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MAKING FEDERALISM WORK IN ITALY

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By

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ABSTRACT/RESUME

Making federalism work in Italy

Fiscal federalism can be an important complement to structural reforms and budget consolidation. Empowering sub national governments, while at the same time making them accountable to local citizens in the uses of tax money, could improve the allocation of public resources and promote catch up of the lagging regions. Italy has launched itself in the federalist direction by decentralising spending, regulatory and tax powers in the late 1990s and reinforcing growing lower level responsibilities with a constitutional reform in 2001. The constitution has yet to be fully implemented, though the government has signaled its intention to do so. A stronger focus should now be put on the financing side, *i.e.* getting a better match between spending responsibilities and taxing powers so as to boost local autonomy and responsibility in line with the goals of federalist reforms. As the lower levels are fully in charge of health and long term care, they will face intense pressures due to population ageing, which is especially rapid in Italy, so that more tax bases should be devolved to them, especially as pension reform has reduced such pressures on central government. Redistributive mechanisms should be redesigned to improve fiscal effort, and Italy must decide in that context to what extent it can really afford to guarantee uniform national service levels – and conversely, how much regional differentiation of services it will tolerate in pursuit of higher efficiency. Framework conditions need to be strengthened, notably accounting standards which need to be upgraded and unified. Fiscal discipline under the Internal Stability Pact should be strengthened via better *ex ante* co-ordination and tougher sanctions *ex post*.

JEL classification codes: H71, H72, H75 and H77

Key words: Italy; fiscal federalism; decentralisation; regions; provinces; local authorities; public spending; efficiency; health care.

Faire fonctionner correctement le fédéralisme en Italie

Le fédéralisme budgétaire peut être un précieux complément des réformes structurelles et des mesures d’assainissement budgétaire. Donner plus de pouvoirs aux administrations infranationales tout en faisant en sorte qu’elles rendent des comptes à leurs administrés pour l’utilisation des recettes fiscales pourrait améliorer la répartition des ressources publiques et favoriser un rattrapage dans les régions en retard. L’Italie s’est lancée sur la voie du fédéralisme en décentralisant les dépenses, les pouvoirs réglementaires et les attributions fiscales à la fin des années 90 et en renforçant les responsabilités croissantes des niveaux inférieurs d’administration par la réforme constitutionnelle de 2001. Mais les nouvelles dispositions constitutionnelles ne sont pas encore pleinement appliquées. Le gouvernement a l’intention d’y remédier. Il faudrait maintenant mettre davantage l’accent sur le volet financier, c’est-à-dire faire mieux concorder les obligations de dépenses et les compétences fiscales, de manière à renforcer l’autonomie et la responsabilité des autorités locales conformément aux objectifs des réformes fédéralistes. Les niveaux infranationaux d’administration, qui ont totalement en charge les soins de santé et la dépendance des personnes âgées, devront faire face à de très fortes pressions du fait du vieillissement de la population, particulièrement rapide en Italie ; il faudrait donc leur décentraliser plus de pouvoirs fiscaux, sachant en particulier que la réforme des retraites a réduit les pressions qui s’exercent sur l’administration centrale. Il faudrait revoir les mécanismes de redistribution dans la perspective d’un plus grand effort fiscal et, dans ce contexte, l’Italie devra décider dans quelle mesure elle peut véritablement se permettre de garantir des niveaux nationaux uniformes de prestation des services publics – et, à l’inverse, quelle différenciation régionale des services elle tolérera en vue d’une plus grande efficience. Il faut renforcer les conditions cadres, en particulier les règles comptables, qui doivent être améliorées et normalisées. On pourrait obtenir plus de discipline budgétaire dans le cadre du pacte interne de stabilité avec une meilleure coordination ex ante et de plus lourdes sanctions *ex post.*

Classification JEL : H71, H72, H75, H77

Mots clés : Italie ; Fédéralisme fiscal ; Décentralisation ; Régions ; Provinces ; Autorités locales ; Efficacité des dépenses publiques ; Système de soins

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MAKING FEDERALISM WORK

By Alexandra Bibbee[1]

1. Italy in the late 1990s embarked on a path of fiscal decentralisation *cum* liberalisation and confirmed the new orientation with major, so-called "federalist", constitutional reforms in 2001. These reforms reflected a fundamental desire to boost quality of government in support of better economic and fiscal performance, recognising that a market-based and competitive economy requires a more efficient government that is accountable to citizens' general welfare, providing "value for tax money".[2] Federalism could supposedly achieve these goals by bringing the supply of government services closer to the interested taxpayer-users, and the way was shown by decentralising country experiences in the OECD. Federalism also seemed to be an answer to Italy's problem of a deep regional divide.

2. This chapter aims to enhance understanding of the federalist process in Italy, and to suggest some guidelines for its further development. The first part looks at the main trends and forces pushing in the direction of decentralisation as a response to Italy's larger challenges. The second section takes up some key issues on the spending side, mainly within the optic of how devolution can deliver on its promise of efficiency gains. The third section turns to the financing side, asking how reforms there could stimulate the local accountability upon which any successful federalism rests. The final section examines "credible" fiscal rules and processes to ensure compatibility between growing local autonomy on the one hand, and respect of European fiscal commitments for the whole of Italy, on the other.

3. The chapter's main messages could be summarised as follows. Fiscal federalism goes in the right direction for Italy – provided it is well done. Significant progress has been achieved but it needs to be followed through to a satisfactory conclusion. The legislative space and basic knowledge to do so is there: the 2001 constitutional reform defines the broad framework for a coherent federalism. But in the five years since its enactment, little has been done by way of implementation. There have been frictions regarding overlapping spending competencies, vertical tax competition and sharing of the fiscal consolidation burden. But the core problem seems to be an equity/federalism trade-off, in particular in the transition to federalism during which redistribution mechanisms have to be adapted to more efficient outcomes. The apparent unwillingness or inability by regions to agree thus far on such a trade-off has led to some policy incoherence. While decentralising spending functions Italy has tried very hard to devolve tax bases and

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1. This paper is based on material presented in the *OECD Economic Survey of Italy* published in May 2007 under the authority of the Economic and Development Review Committee (EDRC). The author would like to thank Val Koromzay, Andrew Dean, Mike Feiner, Patrick Lenain, Mario Pezzini, Hansjoerg Bloechliger, and Romina Boarini for valuable comments. The paper has also benefited from discussions with numerous experts, including from the government. Special thanks go to Sylvie Foucher-Hantala for technical assistance and to Chrystyna Harpluk and Deirdre Claassen for technical preparation.

2. The 2007-11 DPEF states that: "A fully implemented fiscal federalism has become a condition for achieving two key requirements: for local governments to be able to perform their functions in full; and for the system of public accounts to be balanced."

transfer sufficient resources on top, while also imposing regulations on service uniformity, in order to safeguard against possible under provision of public services by lower level governments. It has at the same time attempted to enforce efficiency in such service provision via fiscal rules and periodic limits on tax autonomy and state transfer flows. However, the rules did not function properly and the bargaining mechanisms in their place resulted in soft lower level budget constraints. The result is that federalism is still very much work in progress in Italy.

4. These considerations will lead to a set of recommendations that should be seen as an integrated whole rather than a sequence of steps. Notably, good fiscal rules should complement and reinforce an internally coherent system of fiscal federalism. The key points can be summarised as follows (see Box 6):

- *Spending autonomy.* Set national social service guarantees at basic yet adequate levels, allowing regions to top them up as their own resources allow. Provide regulatory scope for local wage and personnel determination (equivalently, a looser grip of national bargaining and contract rules). Conversely, circumscribe "autonomy" to violate national competition policies in tendering and procurement practices, zoning laws, privatisation and governance of public enterprises, etc.;

- *Revenue autonomy.* Recent unfreezing of tax rate flexibility is beneficial and should go further by widening room for tax rate variations – the key to local autonomy and accountability. More tax bases should be devolved, as ageing pressures are shifted to lower level spending, and national level taxes correspondingly reduced. The state should also minimise its interference with tax bases (*e.g.*, IRAP and ICI) or co-payments (*e.g.*, pharmaceutical ticket);

- *Hardened budget constraints*. Set equalisation transfers in line with standard costs of national social service obligations, and less than 100% equalisation of tax capacities for other spending in order to encourage tax base development. Reduce role of discretionary transfers accordingly;

- *Credible fiscal rules*. The current move toward deficit rules rather than spending ceilings for local authorities is warranted and should be generalised to regions. Sanctions for non-compliance should include reputation costs for local officials and (as currently) tax costs for citizens who elect them. Standardise accounting practices across all levels to enable proper monitoring;

- *Institutional arrangements for efficient bargaining*. Rules on equalisation transfers and budget deficits should be decided in a co-ordinated fashion in order to be credible. Horizontal equalisation arrangements may be more transparent than vertical ones. Deficit rules should be decided in tandem with central government at the start of the budget process.

The evolution of fiscal federal relations in Italy

5. Fiscal federalism in Italy has evolved in several steps with the aim of improving the efficient delivery of services (Box 1). The general picture is that the constitution calls for a rather high degree of federalism but its implementation has been highly non-linear and uneven, given political disagreements and distributional issues. Today's level of decentralisation was largely achieved by the end of the 1990s and more remains to be done, particularly as regards financing, but future uncertainties loom large. A main risk to be avoided is that the constitution be interpreted so as to justify a return to derivative financing of the 1980s.

Box 1. The federalist process in Italy

Creation of the regions and centralisation of financing

In 1948, a new constitution requiring a federalist set up was adopted under the influence of the United States in the post-war setting. At that time only 5 "special statute" regions (border areas and islands) were created, but they were granted extensive spending autonomy and central funding which cannot be changed by ordinary law.[1] In 1970, a fully fledged regional level of government was created, consisting of 15 new "ordinary" regions plus the original 5 special statute regions, all being superimposed upon the extant provincial and community levels. Large (health) expenditures were devolved to the regions whereas local tax powers were heavily centralised, and in this sense the regions served mainly as a sort of administrative arm of government.

Liberalisation push of late 1990s-2000: more local autonomy

In the 1990s, economic crisis and Italy's bid to join EMU forced a deep rethinking of federal relations in the context of a broader liberalisation movement. The 1998 Bassanini reforms devolved spending and regulatory functions involving interface with citizens in line with the principle of subsidiarity. The 1998 Bersani reform at the same time made significant steps toward liberalising markets. Decentralised government services were meant to promote, and in turn benefit from, greater market competition. A system of "negotiated planning" was devised for poorer regions, with more active involvement of local governments in project preparation allowing them to better absorb EU structural funds. On the financing side, specific state transfers were replaced by tax sharing and equalisation schemes, and the new spending responsibilities were accompanied by a substantial block of new regional taxes allowing some latitude in setting tax rates for local needs: notably a regional tax on company value added, the IRAP (*imposta regionale sulle attività produttive*) and national income tax surcharges for all levels. A reform of the system of equalisation transfers was passed into law in 2000, but never implemented as tensions over potential losses of transfers surfaced.

The 2001 reform of Title V: consolidating the federalist process

The division of spending and regulatory powers

In 2001, a major reform of Title V of the Constitution, governing the distribution of powers across levels of government, was passed just prior to national elections (and later ratified by national plebiscite). *Articles 117* and *118* gave precise breakdowns of spending responsibilities, while also allowing for a potential "multi-speed" federalism, *i.e.* temporarily differing degrees of autonomy in different regions.[2] Areas of exclusive central government and concurrent central and regional government competencies were specified in various spending and legislative areas – all areas not so specified were assigned to the exclusive competence of the regions by default. Clearly this reallocated much power to the regions, as not all potential areas could be enumerated. Regions were for the first time also accorded legislative powers in areas of their exclusive competence in both spending and tax areas. However, power sharing in the areas of overlapping competence was not clear and became the genesis of numerous conflicts subsequently.

The government that came into power in mid-2001 (Berlusconi) made a number of follow-up constitutional reform proposals, wanting to put its own imprint on the reform. The regions, meanwhile, did not fail to grasp the significance of the new provisions for their own powers, and they brought numerous cases before the Constitutional Court. The Court subsequently passed a series of decisions interpreting the constitution, having the force of law and tending more often to rule in favour of State powers than of the regions. In the hotly contested areas of overlapping competencies, the Court stated that responsibilities should be split up as follows: *a)* the central government legislates fundamental principles (for instance, general norms for health protection) for the area in question; *b)* the region undertakes financing, administrative, and management functions for the spending; and *c)* the local authorities perform "hands on" delivery of services unless there are cogent reasons to do so at a higher level. Meanwhile, the legal process (widely considered to be a more democratic and consensual way of proceeding) was held up in Parliament by a long debate. Regions' new powers of legislation in the tax area were never realised because the national Parliament failed to define the required framework law. Finally a "devolution" law, re-specifying health, education and administrative police as areas of exclusive (rather than shared) regional competence, and the creation of a Chamber of Regions was passed just prior to the April 2006 national elections, but it was not confirmed by national referendum the following June.

Local government financing reforms

The new Title V also called for a revolutionary new financing model under *Article 119*. It implied virtually complete revenue autonomy for lower levels to finance their normal activities, topped up in poorer regions by a new rules-based equalisation fund, with only a marginal role reserved for discretionary central government transfers to fund

"extraordinary" spending. Local governments could borrow to finance their investment expenditures (golden rule). But unlike on the spending side, the separation of powers in terms of precise revenue sources was left vague.

There was even a clawing-back of regional taxing powers in practice. The government made clear its dissatisfaction with IRAP, echoing the complaints of the business community which had also mounted legal challenges, and vowed to phase it out. However because of fiscal constraints, only selected deductions were in the end accorded. The Constitutional Court ruled that IRAP was a national, not regional tax, prompting the government to freeze regional tax autonomy in 2002 while cutting transfers to regions in line with its earlier electoral promises to lower the tax burden; however such autonomy was restored in 2006. The European Court examined the legality of IRAP in light of EU rules on VAT harmonisation, but in the end ruled in Italy's favour despite the adverse opinion of its own legal counsel.

A High Commission on Fiscal Federalism was formed in 2003 to draw up a set of proposals which should form the basis of a government draft law. After several extensions of its deadline, Commission presented its report only in late 2005 to which there was no legislative follow-up. The Commission was abolished in 2007 by the new government that came into power in 2006 (Prodi), which proceeded to put two draft laws before Parliament, respectively clarifying spending assignments (local autonomy code) and liberalising the supply of local services. It also vowed to implement Article 119 as a future reform priority, and a draft law specifying the financing framework for all sub national levels of government was presented to Parliament in the summer of 2007.

1. For Friuli-Venezia Giulia and Sardegna, however, some parts of the statutes can be changed via ordinary law.

2. The region of Lombardia in late 2006 made proposals to avail itself of such a "multi-speed" federalism, wishing to go ahead with greater spending and tax autonomy before the whole country is ready to do so.

6. As a result of the devolution during the 1990s, the share of the sub-national level in general government spending rose from about 15% in 1990 to almost one third by 2005, around the OECD average and somewhere between unitary countries like France and United Kingdom and federalist countries like United States, Canada, Australia and Germany (Figure 1). Leaving out spending on social security and interest on public debt, which are particularly large in Italy, sub national governments are responsible for one half of government spending (Figure 2). A large share of sub-national spending in the hands of (many) local entities of around one half, compares with a more dominant role for regions in most other OECD federalist countries. Local entities in turn are comprised of communes and provinces. The latter is by far the smallest of the four levels and seems unique in the OECD context (below).

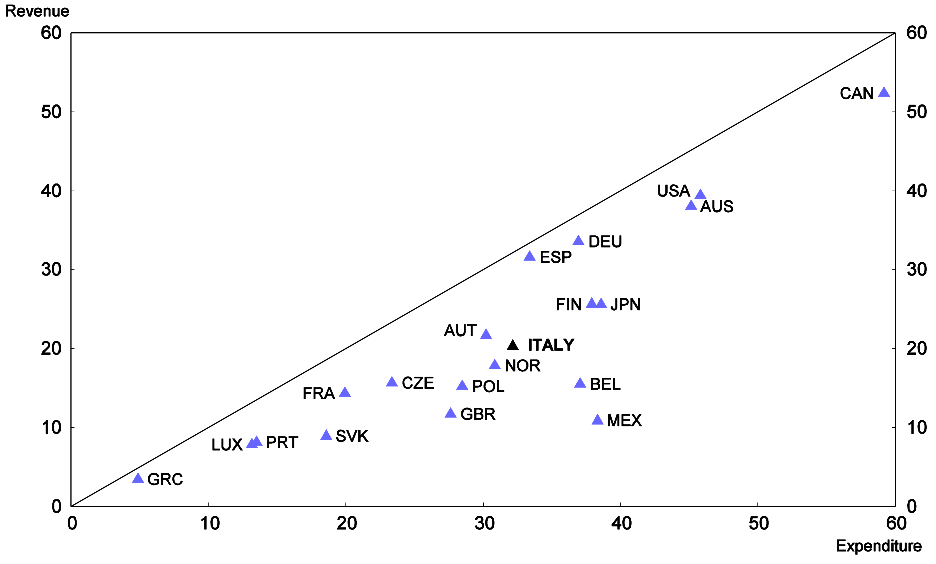
7. The spending assignments across levels appear to obey the principle of subsidiarity. Virtually all public services to individuals are devolved (Table 1). Regions focus on health spending, which covers 60% of their total expenditures, as well as transport, vocational training and labour market services. Local entities are responsible for most infrastructure spending as well as welfare services, territorial development, local transport and police. The central level is left with collective provision in tax collection, macroeconomic policy, income redistribution, defence, justice, and debt service, in line with its comparative advantage (Figure 3). The main exception is education, a merit good provided by the state but which according to the new constitution should be devolved to regions, as is typically the case in other federalist countries of the OECD. Devolving education would increase regions' spending bill by one-third.

Table 1. Sub national government competencies
According to the 2001 constitutional reform

Responsibilities of municipalities	Responsibilities of provinces	Regions
Town planning	Road network maintenance	Health
Social housing	Transport	Health centres and hospitals
Aid to the disabled	Secondary schools (construction of buildings)	Vocational training
Local public transport	Environment including protection and improvement of the energy resources	Culture
Road network maintenance	Cultural heritage	Town planning
Local police	Household waste and sewage	Road networks, civil engineering and regional railway transport
Pre-elementary, primary and vocational schools (building construction and maintenance and teachers' pay)	Some health services	Agriculture
Culture	Vocational teaching	Country planning and economic development
Sport	Economic development	Environment
Sewage and waste disposal	Management of employment services and subsidies	Social services
Upkeep of pharmacies in rural areas		Education

Source: ISAE.

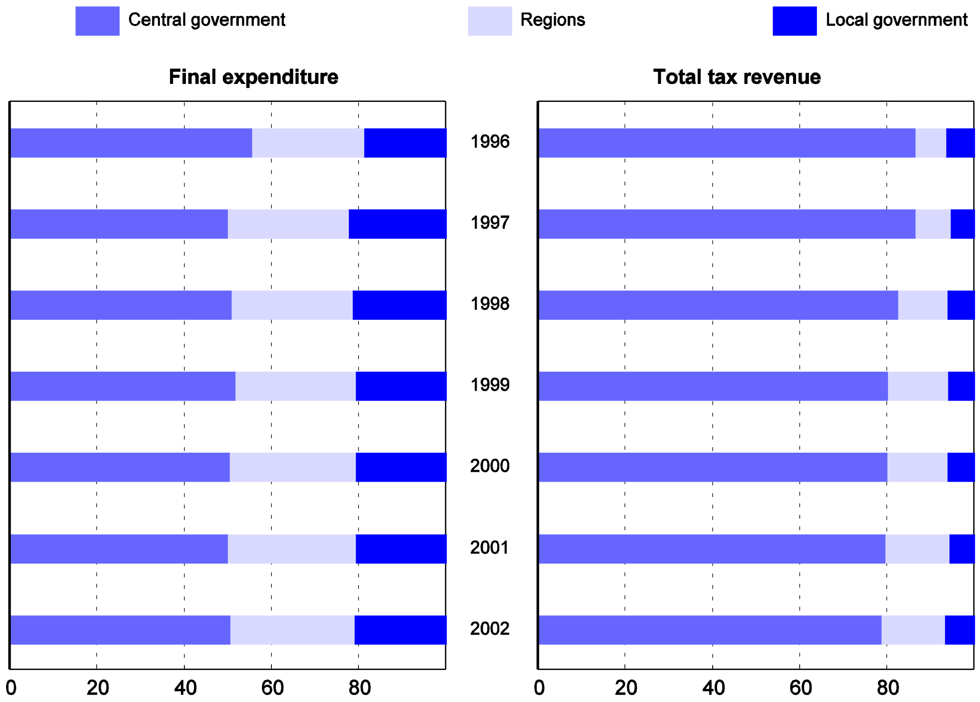
Figure 1. Indicators of decentralisation: an international comparison[1]
Sub national shares of revenue and expenditure in per cent of total general government



1. 2002 for Mexico, 2003 or 2004 for other countries.

Sources: OECD Annual National Accounts database, May 2006; Belgostat; Statistics Canada; Statistics Norway; US Bureau of Economic Analysis; Australian Bureau of Statistics; Ministry of Economy and Finance, *Relazione Generale sulla Situazione Economica del Paese*.

Figure 2. Spending and tax shares by level of government
As a percentage of total, 1996-2002



Source: Buglione, E. and M. Marè (2007), "Main issues of Italian Fiscal Federalism", Working Paper SIEP.

8. Sub-national spending is financed by a mix of own revenues, state transfers and debt. New tax assignments have largely kept pace with new spending responsibilities (Figure 2), but the devolution of tax and spending authority remains highly disproportionate: sub-national tax revenues cover less than half of their current expenses. With non-tax revenues such as user fees and tariffs also underdeveloped, this leaves a substantial role for state transfers (some 9% of GDP). Italy is thus still some distance from the diagonal (full self-financing) in Figure 1, in contrast to mature federations like Canada, United States, Australia, Germany and Spain. However, it should be emphasised that Germany and Australia count VAT sharing as "own resources" while Italy as a transfer. This is likewise reflected in a vertical financing gap (Figure 4). Nevertheless, the make-up of transfer financing has changed in a positive direction: the share of central specific grants dropped from close to 90% in 1995 to around 50% by 1998, being replaced by national tax sharing and equalisation arrangements. These latter schemes, in principle based on clear, objective and stable rules rather than discretion, are considered by the OECD to be more conducive to spending discipline than grants.[3] They also may have given rise to a growing lower level debt (below).

9. In Italy's case, tax sharing and especially equalisation arrangements are not very obviously rules-based or consistent: *i)* special regions are in good financial shape thanks to more devolved tax bases and very generous sharing of national taxes collected on their territory, while the richer ones do not have to contribute to equalisation transfers destined for poorer regions; *ii)* ordinary regions lacking such advantages incur a collective vertical fiscal imbalance, requiring state equalising transfers that are largely based on historical spending; and *iii)* municipalities show a vertical imbalance of similar magnitude to that

3. See Joumard and Kongsrud (2003). Certain sharing arrangements could be classified as own taxes if sub-national governments participate in the rules-setting or if the central government distributes the entire tax revenue, as is practically the case for the Italian special statute regions.

of ordinary regions, with the associated equalisation transfers largely based on tradition often with no obvious economic rationale. As there is little hierarchical structure across levels, cities report directly to central government and individually negotiate for funding, bypassing the region. This may reflect the long history of local power in Italy, and relatively recent creation of the regions. With also little accounting standardisation across the various entities, fiscal federal relations can be cumbersome.

10. Local authorities have the right to incur debt for investment spending, reflecting a constitutional "golden rule". Local level debt has been rising far faster than central government debt, though from a much lower base (Figure 5). Whereas national tax sharing revenues have compensated for simultaneous reductions in grants, and own revenue (notably property tax) has remained static, expenditure is dynamic.[4] Thus, local authority current spending has in recent years risen by 2½ per cent per year, like that of the state in line with inflation, but revenues have risen by less than ½ per cent per year (state revenues 1¼ per cent),[5] and investment spending growth has also been compressed.[6] Regions can incur debts within certain limits fixed by central government (mostly as a percentage of revenue from taxes and ordinary transfers), but large health spending overshoots have had to be covered by growing suppliers' credits, securitisations of such credits, and finally *ex post* state transfers. The latter bail-outs create a "soft" budget constraint that only exacerbates the syndrome of overspending and creative accounting by regions. As total local government spending has risen at a pace about double that of central government in recent years, and given that local authority spending has been strongly squeezed, regional spending has by implication grown much faster than at any other level (Table 2).

Table 2. Spending dynamics

	% change			Level (€ million)
	1999-2002	2002-05	1999-2005	2005
General government spending				
Current	13.8	11.1	26.5	630.2
Capital	5.9	21.6	28.7	57.1
Total	13.2	11.9	26.7	687.3
Central government spending				
Current	8.7	11.0	17.2	354.5
Capital	28.0	-14.4	-1.3	30.3
Total	10.4	8.4	15.6	384.8
Local government spending				
Current	25.7	15.0	39.7	181.2
Capital	16.6	11.5	35.8	37.2
Total	24.0	14.4	39.0	218.4

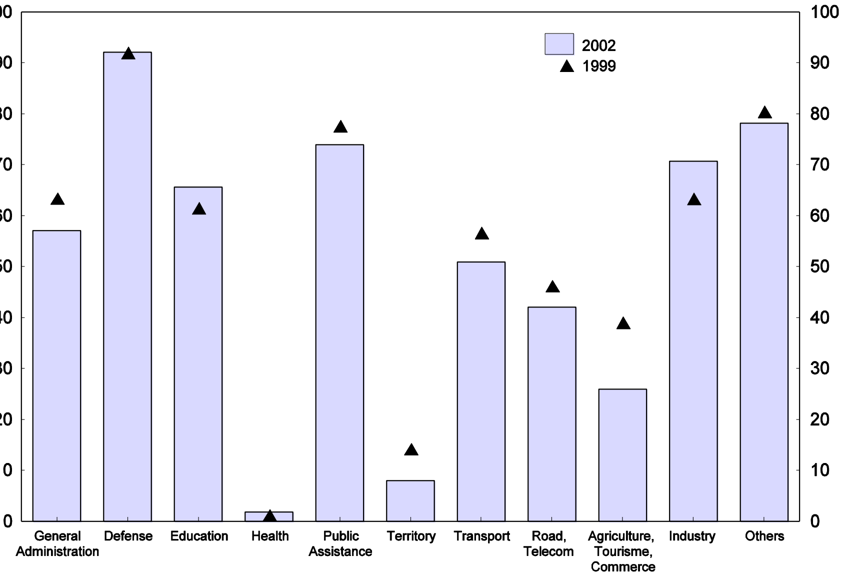
Source: ISTAT, *Conti territoriali delle Amministrazioni pubbliche*.

4. Also, unlike the state, communes cannot by law refinance maturing debt by new debt, so that amortisation adds to current spending needs (Ghisellini, 2007).

5. See Ghisellini, *op. cit*.

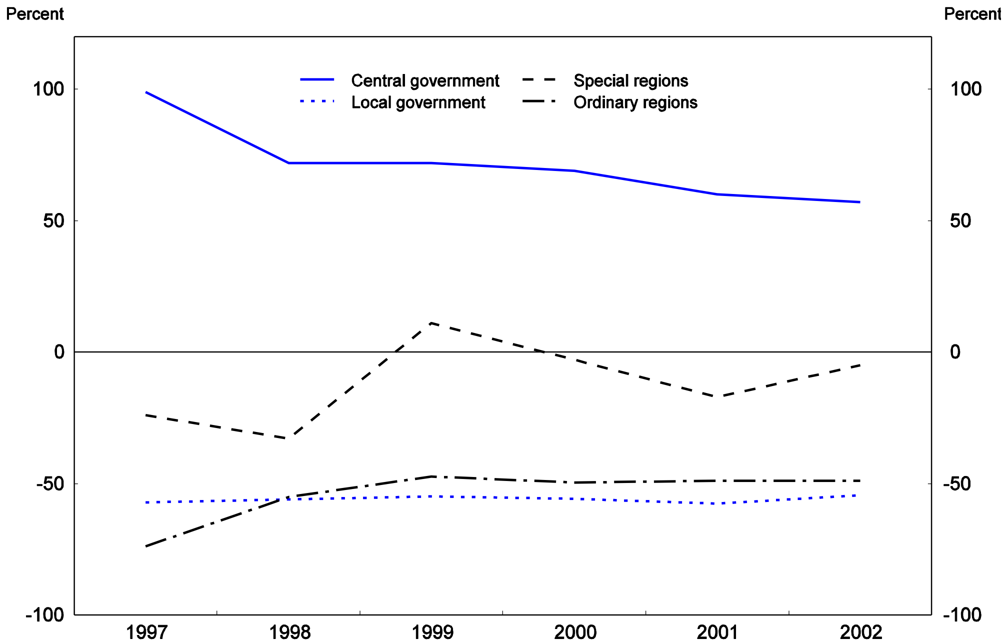
6. Fieri (2005) discusses ways in which the local authorities have attempted to circumvent these constraints while also evading the strictures of the Internal Stability Pact, such as creation of separate management units, strategic privatisations and other accounting tricks to shift spending off budget.

Figure 3. Central government spending by function
As a percentage of general government spending



Source: Buglione, E. and M. Marè (2007), "Main issues of Italian Fiscal Federalism", Working Paper SIEP.

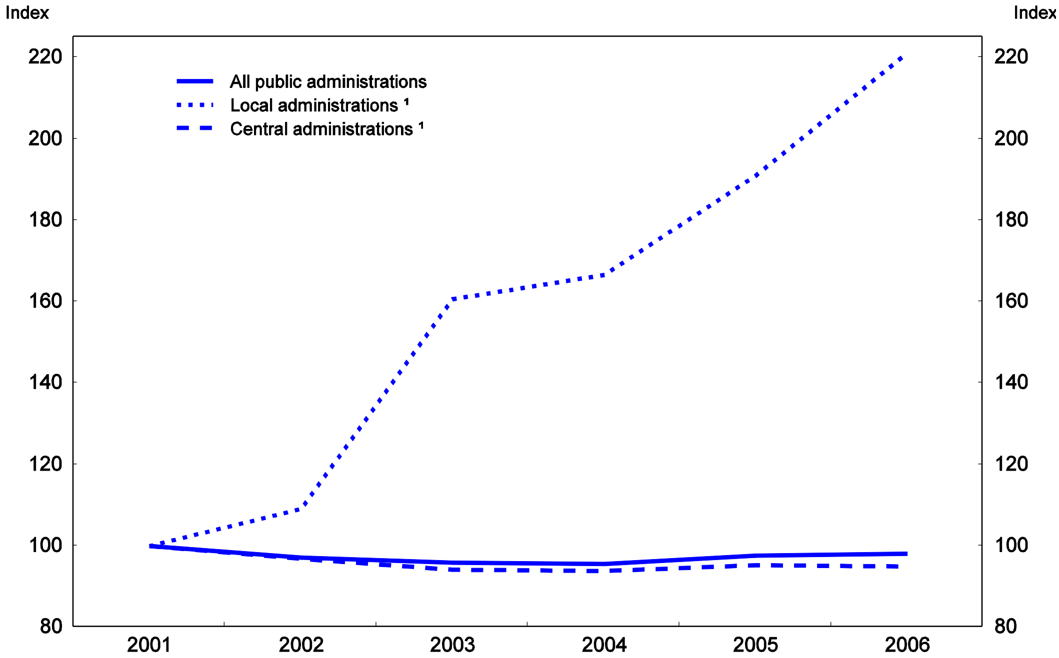
Figure 4. Vertical fiscal balance by level of government[1]



1. Fiscal balance defined as tax and non-tax revenues less final spending, expressed as a percentage of final spending.

Source: Buglione, E. and M. Marè (2007), "Main issues of Italian Fiscal Federalism", Working Paper SIEP.

Figure 5. Debt by government level
As a percentage of GDP (2001 = 100)



1. These series are affected by privatisation of the Cassa Depositi and Prestiti in 2003, which shifted debt from central to local levels.

Source: Banca d'Italia, Supplement to the Statistical Bulletin: The Public Finances.

Spending issues

11. Given that devolution has already gone quite far in Italy on the spending side, a tentative *ex post* evaluation should be possible, in particular to see whether the reallocation of functions to lower levels has improved the effectiveness and cost efficiency of public spending.

Efficiency in social services

12. The delivery of social services, notably health and (potentially) education, comprises the lion's share of regional spending but, these being areas of concurrent competencies, "fundamental principles" are the prerogative of the state (see Box 1). The state must also set national standards of service in the social sphere (*Livelli Essenziali di Assistenza*, LEA), and guarantee the financing to achieve them in every region. National standards on service quality and access, if set coherently with fiscal sustainability needs, can make federalism reforms more palatable and protect shared equity goals during a transition period,[7] reducing the risk of under-provision that sometimes accompanies decentralisation of services.[8]

Health

13. Health is the sector most critical for fiscal federal relations and emblematic of their problems. The regions are free to organise the delivery of health care services in their territory with minimal

7. Pammolli and Salerno (2004b) stresses this point.

8. See Joumard and Kongsrud (2003).

interference from central government, apart from the LEA minimum standard requirements. The actual running of the services is in turn devolved to the regional health enterprises (RHEs), a sort of local authority. This organisational freedom is reflected in innovative health care models. Provider-purchaser splits came with creation of the RHEs, allowing proto-market competition. Modern techniques of financing and running the RHEs have been developed by "best practice" regions, including the use of DRGs (diagnostic related groups) in addition to *ex ante* budgets to allocate funding and the use of professional managers to administer hospitals.[9] At the macro level, performance looks satisfactory: Italy's health outcome indicators are situated in the medium-to-high end of cross country comparisons while health care spending (7 and 9% of GDP, public and total, respectively) is only slightly above OECD average. But the dynamics are more worrying.

14. In each year since Italy has presented stability programmes to the EU, health spending has risen up to 15% of the full long run increase to 2050 projected in the previous year's programme.[10] According to OECD projections, which incorporate stronger income effects than the national projections, health and long term care spending for Italy will double between 2005 and 2050, from 6½ to 13¼ per cent of GDP, 2% of which is due to demography and the remainder to income effects (OECD, 2006). The government has attempted to control the growth of spending by tri-annual Health Pacts. But by now spending is almost 1% of GDP above the target set in the first Pact and health spending continues to exceed a moving target (Table 3), even after suppliers' credits and other creative accounting noted above. Hoping to force lower spending, the state for a time (2002-05) froze regions' autonomy over tax rates and health co-payments (below). But the regions just blamed health deficits on the need to satisfy high national standards on health and (with the support of the constitutional court) demanded more *ex post* transfers from the State. Such transfers were provided under periodic clean-up operations (*sanatoria*).

Table 3. Health deficits

	2001	2002	2003	2004	2005	2006
Spending of the SSN						
€ billion	76.0	79.5	82.3	90.5	96.8	99.2
% of GDP	6.1	6.1	6.2	6.5	6.8	6.7
Health Agreement/Budget						
€ billion	71.9	76.7	80.0	84.7	91.1	95.0
% of GDP	5.8	5.9	6.0	6.1	6.4	6.4
Deficit						
€ billion	4.1	2.9	2.3	5.8	5.7	4.2
% of GDP	0.3	0.2	0.2	0.4	0.4	0.3

Source: Ministry of Health.

15. The health spending overshoots could reflect either that *a)* the targets themselves are unrealistic, given strong push factors like population ageing and technology, or *b)* regions are inefficient in the uses of health care resources. If the former is the case, then *ex ante* budget allocations should be increased to realistic levels with stronger sanctions for *ex post* deficits. If the problem is inefficiency, then funding is OK but controls should be all the stronger. Since the financing of health care is decided in a sort of bargaining game between regions and state, both factors could be at play. However, inefficiency seems to be the core problem given that the game motivates higher spending to capture even more transfers down the road – the antithesis of responsibility and federalism principles.

9. Regarding health and decentralisation see OECD (2007b).

10 . See Pammolli and Salerno (2006).

16. There is indirect evidence of resources waste. Despite near equalisation of per capita health care resources across regions, outcomes differ widely as suggested by substantial inter-regional migration for hospital and specialist services. The migration goes overwhelmingly from south to north, and even if it is sometimes based on perceived rather than real differences in service quality, there is enough anecdotal evidence to support the notion of lower productivity in some parts of the south[11] – apparently substantiating "Wildavsky's law" that where resources are fewer, there public management is also poorer.[12] But even where quality is higher, cost control may still be weak. Indicators point to "supply-led demand" inefficiencies in certain regions found in all parts of the country, *e.g.* inappropriate use of hospital services or excessive procedures and drug prescriptions.[13] Furthermore, accounting practices at the regional health enterprises can be slipshod, which prevents sound management; only one region (Tuscany) has been able to pass external audits of its health enterprise accounts. Indeed, the scope for efficiency savings in Italy's health sector has been estimated at 20-30%.[14]

17. The upshot is that there clearly exist cost pressures now and in the future. Hence, taxes will have to increase, and the central government has dealt with this problem by making this the responsibility of the regions, giving them more tax instruments (Box 2). Yet Italy needs lower tax rates, to spur investment in the catching up regions and to cope with the globalisation challenge in the industrial north. Because of the decentralisation process, however, tax rates should be lowered at the national, not sub-national, level. At the same time, greater cost efficiency is required to contain such local tax increases and it will result from transferring to regions spending responsibility accompanied by greater tax autonomy and harder budget constraints. A well functioning federalism, based on accountability, would provide support to contestability and efficiency of public health care services. This would enable eventual easing of local tax pressure and attenuate cross-regional health sector productivity differences.[15]

11. For example, the problem of "double dipping" – doctors who are nominally full time public servants while using public facilities to treat private patients – may be more acute in some areas of the South, as are phenomena like unfinished hospitals and stolen or neglected medical supplies and pharmaceuticals. Even though such problems should be getting better as controls are tightening (*e.g.* anti-Mafia certifications of construction firms), these controls also introduce a lot of red tape into local administration project implementation.

12. See Pica (2005).

13. See Corte dei Conti (2006), Table 11. The Lazio (Rome) region with its many public teaching hospitals and closeness to central government has exhibited especially large overruns. There is evidence in this region that private (mainly Catholic church) hospitals provide services much more efficiently than public ones, but competition among them is weak or nonexistent.

14. See Reviglio (2007).

15. The experience of countries like Norway suggests a home-bias in use of health care services. That is, given a choice, people prefer to be closer to home in the event of hospital stays so long as care quality is not too unequal across the country (Bibbee and Padrini, 2006).

Box 2. The 2007-09 Health Pact with the regions

A new Health Pact with the regions covering the period 2007-09 was entirely incorporated into the 2007 Budget Law. It prolongs a key innovative measure of the 2006 Budget, reinstating formerly frozen regional tax rate autonomy while requiring deficit regions to increase their two chief taxes (IRAP and surcharge on personal income tax) to the maximum rates allowable. It further imposes a structural deficit reduction plan, agreed with and monitored jointly by the Ministries of Health and Economics, aimed at cutting costs including reduction of hospital beds. This plan may temporarily involve additional public resources. In case of non-adherence to the plan, it is possible that regions would be required to raise tax rates even beyond current allowable maxima (to stimulate responsibility). For those regions, the off-the-books debts to suppliers are being repaid via special long term state "loans" to regions, amounting to 0.2% of GDP in 2007, which will eliminate distortions in the market and budgets while avoiding the payment of regional risk premia on market debts. The size of such debts may be significant, in particular for Lazio, but is still being estimated within the ambit of the health sector restructuring plans.

Pharmaceuticals prices will continue to be squeezed by the exercise of centralised government monopsony power. Patient copayments ("ticket") will be activated in new areas like emergency room and ambulatory services, to stem excessive demand. Committees are being set up to revisit the LEA and to analyse their costs and associated financing mechanisms in health care. Central government financing of € 3 billion is provided for hospital restructuring investments.

Finally, the Ministry of Economy and Finance and the Ministry of Health, in agreement with the regions, should elaborate suitable guidelines and models to be adopted by health care enterprises in reporting health accounts. Currently, the treatment of capital is based on how the entities happened to treat inherited capital at their creation, with imprecise and non-homogenous rules on amortisation rendering territorial balance sheets non-transparent and distorted for many years (Persiani, 2006).

All this suggests that developing other mechanisms to make regions co-responsible in their spending governance may be urgent:

- *Financing* reforms will need to phase out funding based on historical spending and *ex post* bargaining in favour of one linked to *ex ante* structural factors (with credible sanctions for spending overshoots). A committee will present in the course of 2007 proposals for new financing rules based on micro methods including standardised processes and inputs.

- The *LEA* should, in parallel, be defined not in terms of equal per capita spending independently of productivity but rather of cost efficiency for each type of service, upon which its financing is conditioned. To this end, standard cost benchmarks should be developed by central government, drawing on experience with the systems (such as DRGs) developed by certain best practice regions.[16] The menu of "essential" services should be adequate, yet bounded; going beyond them should be a matter of local choice funded by the free exercise of tax autonomy or efficiency savings in spending. An LEA committee has been formed, but hard choices may still need to be made on the scope of the guarantees that Italy can really afford, even if efficiently supplied.

- Appropriate *framework conditions* are needed to underpin better health cost control. Modern accounting principles and their standardisation, already available for the whole public

16. See Pammolli and Salerno (2004a). The national government should also play a strong advocacy role in promoting best practices and measuring outcomes. However, OECD experience shows that it is difficult to set up decent benchmarks and even though better use of DRGs and other measures of efficiency and better accounting procedures are desirable, one should not be too optimistic about what they will achieve (OECD, 2007). It is difficult to instil market-type efficiency in a sector marked by severe information asymmetries. A method would also have to be developed to make adjustments to the national benchmark to reflect outlier costly or complex cases, and to derive standard costs in outpatient and pharmaceutical sectors.

administration, need to be made effective for the regional health enterprises – and these should be made subject to internal controls and external audit.[17] The latest Health Pact (Box 2) has launched the elaboration of guidelines and models allowing such an evolution to take place.

- To the extent that future pressures on health spending are unavoidable because of rapid ageing, which puts greater pressure on regions than on central government (where long run fiscal sustainability has been anchored by pension reform[18]), more and dynamic tax bases should be devolved to the regions via articulation and implementation of *Article 119*, while central tax rates should fall.

Education

18. The Bassanini reforms devolved considerable organisational and didactic autonomy in education straight down to the schools.[19] The state sets the basic framework for standards, curricula, textbooks, etc., monitors results by national testing and assigns financial resources and personnel. The local authorities finance infrastructure investments and maintenance, and the regions are charged with vocational training. According to the new Title V, however, regions should undertake all school financing and management, with the state defining the basic framework and setting standards. This would imply a tripling of local authority spending on education (Table 4) and greatly increase their role in organising education (with even accompanying legislative powers assigned by the constitution) and in hiring and managing teachers.

19. The risks to devolving education are threefold: *a)* still unresolved problems on the financing side; *b)* efficiency problems nationwide exacerbated by the gap in educational performance between the south and centre-north regions;[20] and *c)* excessive overlapping of education responsibility. Besides being politically sensitive, since education touches closely on ideology and citizenship, the state may well be worried about exacerbating inter-regional differences in education quality by a premature decentralisation, wishing to do more to prepare the ground. Its latest policy initiative greatly boosts the central government's presence in testing and coaching schools, especially in the south, while adding significant new resources (€ 4 billion in the 2007 budget) for things like substitute teachers.[21]

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17. Thus far, only the region of Toscana has managed to satisfactorily address accounting issues and satisfy external audits. This might serve as a model for other regions to emulate. See Persiani (2006).

18. On current policies (i.e., prior to the July 2007 government's new reform proposals), pension spending is set to rise by less than 1½ per cent of GDP between now and 2050 (see OECD, 2007a).

19. As discussed in the 2005 *Economic Survey of Italy*, there was a similar radical devolution in universities, but the experiment was not successful as local authorities interfered excessively with personnel decisions to the detriment of teaching and research quality. The state later re-centralised university management but the situation is still not satisfactory.

20. Though primary and secondary education performance has improved with a series of education reforms, scholastic achievement is still at or below OECD averages whereas spending per pupil is way above average (see *Economic Survey of Italy*, 2005). Many classes are sub-optimally small and becoming more so as ageing accelerates. To exploit obvious scope for efficiency improvements, the 2007-11 DPEF calls for a 20% reduction in teaching staff. Quality problems are most serious in the south, where high absentee (both teachers and students) and drop out rates persist. The 2003 OECD PISA study shows some of the lowest scores occurring in the southern regions of Italy.

21. A new nationwide institute has been created to deal with the issues related to school autonomy, Agenzia Nazionale per lo Sviluppo dell'Autonomia Scolastica (formerly INDIRE). Furthermore, a national agency for the evaluation of the performance of the school system as a whole will be created (formerly INVALSI) to carry out various system level and school-based evaluations.

20. Giving authority to schools and their direct reporting to the national ministry is not necessarily undesirable: indeed, devolving some responsibility to the provider level instead of to local government means even more decentralisation and can increase accountability, especially if monitoring is reinforced at the national level, as is the case presently. However, what seems also required is a real revolution in the south's public administration culture, which should normally come about with greater local responsibility, including in education.[22] The very different economic challenges of the north and south might also justify more freedom to differently orient education systems – provided that the state retains a strong guiding and monitoring role to protect national standards, especially in light of current problems. Thus,

- The government should consider a long range plan for implementing Title V as regards devolution of education to the regions, and delegating to local entities while safeguarding the autonomy of schools; the new Code on Local Autonomy could start to define these new roles;[23]

- This would entail the need to devolve or create significant new regional tax bases, increasing further the onus on activating Article 119 on financial autonomy;

- It is crucial that as the state decentralises education it reinforces the steering of testing, curricula, standards (minimal attainment and achievement criteria), and information as it is now doing.

Welfare

21. Non-pension welfare services are poorly developed in Italy. Social assistance has long been under the responsibility of the local authorities, with virtually no involvement or guidance from central government. This has given rise to a free-for-all, with coverage and eligibility for assistance varying widely across regions and localities, reflecting powers and interests of local mayors and creating incentives for welfare migration. The criteria appear arbitrarily tailored to particular cases (*e.g*., physical disability), leaving many needy people outside the safety net. Labour market services for their part were fully devolved to the regions under the Bassanini reforms but remain limited in scope and scale.

22. The new constitutional provisions imply that the national legislature must set the basic framework conditions and LEA for local social assistance policies, although so far it has failed to do so despite reforms proposed by the Ministry of Labour and Social Policies calling for such framework conditions.[24] On the other hand, social welfare setting need not always be centralised. Regions may co-ordinate their welfare systems horizontally without recourse to central government (as in Switzerland). The remaining limited interregional competition limits expenditure pressure.

23. A functional, if modest, social safety is needed to complement reforms in labour markets, product markets and public administration, establishing a missing coherence between welfare policies and structural reform objectives. Establishing limited yet universal unemployment insurance is a long standing discussion in Italy never resolved because of budget difficulties. But precisely because of the budget context, limiting moral hazards of universal insurance will be primordial. Municipalities, equipped with better local knowledge, could probably enforce job search by welfare recipients more efficiently than could

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22. It is interesting that Trentino, a northern special statute region with strong education autonomy, showed the highest score in the 2003 OECD PISA study.

23. If the state decides not to implement this decentralisation then the constitution should perhaps be changed, requiring a national plebiscite – otherwise there might be continual pressures from regions to be given more powers in the education area by claiming constitutional rights.

24. See Saraceno (2005).

the centre. But the state should still co-ordinate information in order to promote geographical mobility and get a better match of skills with openings across the country.

Competition in local economic services

24. Economic services fall mostly under the exclusive competence of regions. Areas covered include regulation of retail distribution, professional and personal services, direct provision of local services and procurement – areas where competition problems in Italy are acute. [25] Local utilities are still overwhelmingly in public hands despite past liberalisation efforts, and decision making remains excessively fragmented. In such areas, however, there could be a downside to excessive autonomy. It could give rise to perverse results in terms of possible capture by local special interests – especially as “civil society” is not very strong. Certain local authorities’ direct participation in local economic service provision tends to preserve monopoly positions and related rents, in part as a “secure” revenue source compared with others. Such authorities may purchase market services from companies in which they have an interest (“in-house”) at inflated prices.

25. The government expressed its willingness to tackle these problems. The Lanzillotta draft law on local public service liberalisation, although weakened from its original version, requires competitive tendering for all public service contracts (except in the problematic area of water), which would help to put public and private providers of market services on a level playing field. However, the draft law has been dragging on in Parliament for a long time, and it is still an object of controversy. If regulatory and other conditions are there, local entities should privatise outright.[26] Re-establishing coherence with national level competition policies formulated to protect consumers, akin to national standards in social services, might also curb the power of local lobbies.[27] There should be a greater recourse to user fees (customers paying for services) in order to reduce dependence on economic rents and grants, to limit the use of distorting taxes, and to constrain demand for public services.

26. The quality of local economic services may be suffering from above-noted tensions in the decentralisation process, which includes a difficult mix of expanding responsibilities, state transfer cuts, limited revenue autonomy and rising debt. Many municipalities have had to cut essential investment spending because of lack of funds.[28] But weak local administrative capacity, bred by a history of passive dependence on transfers and reinforced by a lack of competition in public services, also persists in many cases. Thus, inadequacy of services like water and waste management are reaching catastrophic levels in areas of the south. EU funding has certainly helped, though not entirely. For example, in the Campania region, despite major expansion of the networks (bus and train) made possible by EU structural funds for

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25. Red tape burden also falls under this rubric, remaining excessive even though less so than in the past, and may reflect not only a protectionist device to shelter local incumbents from competitors but also self protection of the public administration, wanting to justify itself by paperwork and preserving its power (or access to bribes) in granting or denying authorisations for often routine activities.

26. Vitaletti (2005) suggests that a major source of the gains from devolution is the greater likelihood that the devolved services will be privatised or quasi-privatised, as being subject to atomistic demand and hence pricing, they are more prone to be in direct competition with private sector production than are services supplied at the national level.

27. A more pro-competitive solution to give play to a broader range of interests (*i.e.* of citizen/consumers) could also help importantly, e.g. more financial autonomy to increase incentives to expand the tax base.

28. Some cities have defaulted on their debts, *e.g.* Taranto after it decided to pay workers before “delegating” current receipts to debt service. Such “delegation” has been the common practice permitting the access to credits in the first place (Ghisellini, 2007).

transport, operating costs cannot be covered so that service levels have had to be cut (such as closing the Naples metro at 10 p.m.) and tariffs were raised.[29]

27. While quality of local administration has improved compared with the past, perhaps more effort has been devoted to project preparation given the incentives of EU structural funds and central matching grants, than to more basic skills relating to good governance. Greater local autonomy should help to develop such broader based skills. Regional policy could well complement the decentralisation process by tackling failures in local capacity and infrastructure in a more targeted manner. Promising new tools have been developed in Italy to reach these objectives, notably novel forms of contracting between central and local governments and output-based funding (Box 3).

Box 3. Regional policies to improve local public service productivity

As of 1992 a *process of radical change in Italian regional policies* has been in progress, partly reflecting the influence of EU economic and social cohesion policies.[1] This process has resulted in: 1) an extension of the targeted areas to less developed areas of the Centre-North; 2) a shift of responsibility from the "Cassa per il Mezzogiorno" (abolished in 1984) to a multiplicity of institutions, including central ministries and territorial authorities (regions, provinces and municipalities), often operating in a system of multilevel governance; 3) an attempt to increase targeting, coordination, monitoring of territorial needs; and 4) a shift from top-down policies to contractual and concerted forms of planning.

At present, the implementation of national territorial development policies rests on a two-tiered system that emphasises *regional policy* and *ordinary policy*. Regional policy is specifically aimed at addressing structural socio-economic imbalances across territories and is financed through additional resources that originate both from the EU budget (structural funds) and from the national budget (the fund of national co-financing to the structural funds and the fund for underdeveloped areas – "Fondo Aree Sottoutilizzate," FAS). Ordinary policy draws on ordinary financial resources coming from the state budget and addresses broader development objectives that are not related to specific territories. Both policies are implemented at various levels by the central government, regions, and local authorities.[2]

In sum, the new approach to regional policy encourages the mutual commitment of different levels of government by the following means: the negotiation of objectives and indicators between levels for measuring their achievement; the attachment of a bonus and sanction mechanism (in addition to the bonus and sanctions "performance reserve scheme" attached to EU grants); and the assessment of the achievement of targets by a specific tiers body.

These innovative regional policy tools could help to solve certain *paradoxes or contradictions arising in the federalist process*, particularly during the awkward transition when governance capacities of some local governments may seriously lag their rising fiscal and regulatory responsibilities. In particular:

- Large disparities in tax capacity and spending efficiency across Italian regions stem from very differing levels of development. This surely limits the effective exercise of spending and tax autonomy for the lagging regions. Regional policy, which identifies place-based problems and opportunities, could be adapted for addressing these issues. Regional development policy, and in particular, the improvement of the distribution of infrastructure, would help to support more effective local economic projects and thereby develop the local economy and tax base.

- Some recent initiatives could be underlined. They concern the new National Strategic Framework (Quadro Strategico Nazionale) 2007-13. This strategy selected important local public services (children and ageing people care, waste management and water, plus education with other types of arrangements among levels of government) and a specific region, Mezzogiorno. The strategy proposes indicators for policy objectives in terms of outputs and not inputs (as recommended here) and attaches incentive mechanisms based on performance targets. However, there is a sunk cost to be paid for the building of co-operative relationships and the identification of good tools for motivating performance in order to commit local authorities to achieve certain objectives.

- A too rigid approach to decentralisation – either all responsibility for the central level or all for the sub-central

29. Information based on discussions with local authorities in Campania region.

level – should be nuanced. Specific arrangements can be used, encompassing mutual objectives, rules for commitments of parties and enforcement procedures. Such a contractual approach to federalism has been stressed by some authors.[3]

1. Between 1950 and 1992, the primary objective of Italian regional development policies was the reduction of the long-standing disparities between the northern and the southern regions ("Mezzogiorno") through interventions mostly aimed at industrialising the south (in popular parlance, the "Intervento Straordinario"). Many of these interventions were devised by a central entity, the "Cassa per il Mezzogiorno".

2. See OECD (2007), *Linking Regions and Central Government: Contracts for Regional Development*, forthcoming in April; also F. Barca, M. Brezzi, F. Terribile and F. Utili (2004), "Measuring for Decision Making: Soft and Hard use of Indicators in Regional Development Policies"; Ministry of Economy and Finance, *Materiali UVAL number 2*, November-December.

3. See Spahn, P. (2006), "Contract Federalism", in E. Ahmad & G. Brosio, (eds.) *Handbook of Fiscal Federalism*, Edward Elgar; also OECD *op. cit.*

Costs of devolution

Labour market rigidities

28. A public debate has arisen as to whether the costs of devolution may be unaffordable in the chronically tight budget situation. The size of the total further gross spending transfer from centre to periphery which would be needed to comply with the new constitution has been estimated at € 70 billion (5% of GDP), much of which for education (Table 4). This should however translate into "zero costs" on a net basis – the stated goal of government – insofar as spending at the central level shrinks correspondingly. But costs of transition are usually unavoidable, even though hopefully more than paying for themselves later on with efficiency gains. Other OECD countries' experiences suggest that such transition costs can be high.[30]

Table 4. Gross transfer of spending under future decentralisation
Local authority spending

	€ billions	€ billions	Per cent
Function:	In 2004	Decentralisation of new competencies[1]	% increase
Commercial services	26.0	0.2	0.7
Defence	..	..	..
Public order and security	3.8	..	..
Economic Affairs	34.4	6.9	19.9
Environmental protection	6.1	0.7	10.7
Housing	9.9	0.2	2.4
Health	89.4	0.6	0.6
Recreation	7.9	1.2	15.7
Education	21.1	45.3	214.6
Social welfare	8.7	15.0	172.8
Total	207.4	70.0	33.8

1. Hypothetical and estimated, based on 2001 constitutional reform.
Source: ISAE (2006), *L'attuazione del federalismo*, March.

29. Employment flexibility in the public sector has been pursued, as in the private sector and in many countries of Europe, by putting new hires on fixed term contracts, leaving insiders' acquired rights intact. It

30. See Joumard and Kongsrud (2003).

is thus very difficult to fire or reassign workers, most of whom are tenured, much less move them. Hence, devolution entails a duplication of posts. The experience with the late 1990s Bassanini reforms is not encouraging: of all the functions devolved, it was only in the case of labour market placement services that the same staff actually shifted from working for central to regional government (without actually moving as they were already stationed at regional offices of national government). Otherwise, central staff stayed in place but with no clear responsibilities, and lower levels had to hire new staff using government grants for this purpose. Since the initial devolutions, local hiring freezes have become regular fixtures under the Internal Stability Pact (below), and consequent ageing of the workforce may be hardening resistance to needed innovations. Local authorities are further constrained in their ability to manage the costs of devolved responsibilities because of rigid centralised wage setting in the public sector.[31]

30. Rigid labour markets make decentralisation prohibitively expensive, implying a very long transition period during which efficiency will not improve. Devolution may provide the opportunity for government to negotiate decentralised wage contracts, allowing wage levels to vary with cost of living differences across regions and, ideally, with average regional productivity levels. The so-called "privatisation" of the civil service (begun in the late 1990s) should reach its logical conclusion in flexible work assignments and eased job protections. A recent government Memorandum attempts to tackle such problems, and its success will be important for the future of federalism. However, some of the proposals could go in the opposite way; for instance, the conversion in the national civil service of temporary staff to permanent status could remove the even small margin for manoeuvre in personnel management, although the criteria of this conversion still need to be defined.

Diseconomies of scale in government

31. A further overstaffing issue is a perhaps superfluous level of government that exists mainly to provide jobs. Italy has three sub national political levels, each with its own ministers, staff, electoral, consultancy and representation costs. Transaction costs for government and citizens also increase when there are multiple decision points and authority levels. The "odd man out" here is the provincial level; even though it corresponds to the Anglo-Saxon counties in an administrative sense, unlike them it has real political authority. Numerous calls in Italy to eliminate the Provinces have met with stiff bipartisan resistance. It can be suspected that the reason for their popularity is to a large extent the opportunities they provide to make more political appointments.[32] Indeed, the number of provinces has been steadily expanding, from 92 originally to 107 at present; legislation was passed under the previous government for another 4 to be created; and there have been proposals to add about 30 more. The already high number of cities (more than 8 000) is likewise expanding with steady creation of new "mountain communities" as authorised by the revised constitution, while their average size is already quite low on the OECD spectrum (Figure 6).

32. The present government has rightly put a stop to the further expansion of provinces, and will try to clarify and rationalise their role in the new Code for Local Autonomy. The proposed legislation also offers new incentives for small cities to aggregate; this could slim down bureaucracy, internalise spill-overs and reduce fragmentation in local public service supply.[33] In particular, certain functions could not

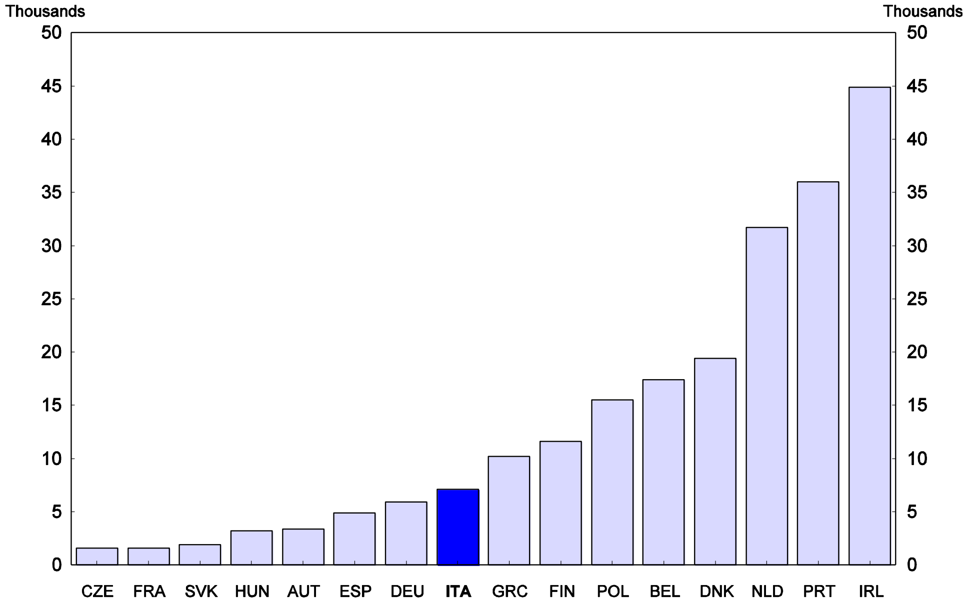
31. Wage moderation is not being observed in the public sector as a whole despite the fiscal crisis: wage awards in 2005-06 were 3% annually, compared with the objective of containing overall spending growth to within 2% (the rate of inflation). Since 2000, wages in the public sector have increased at double the rate in the private sector.

32. See, *e.g.,* Ginafranco Fabi, "Trovare il coraggio di abolire le Province", *Il Sole 24 Ore,* 9 August 2006.

33. There have also been proposals to consolidate the 20 regions into 4 or 5 macro-regions able to guide regional development in a more integrated way.

be exercised unless administrative jurisdictions reached a minimum size (15 000 inhabitants). Indeed, achieving efficiency in local economic services raises questions about the density and scale of jurisdictions. The legislation should try to ascertain what changes in local administrative boundaries and jurisdictions might be appropriate to an environment in which competition becomes feasible.

Figure 6. Size of the cities
Average size of cities: number of inhabitants per municipality



Source: Hemmings, P., “Improving public-spending efficiency in Czech regions and municipalities”, OECD (2006), OECD Economics Department Working Paper No. 499.

Funding principles

33. The method of financing is critical to creating incentives for the local public administration to be accountable in its use of taxpayers’ money.[34] The new constitution is not very clear on the precise model of financing that should be chosen, unlike in the area of spending. But a vague constitution can also be more robust. The important principal that it does establish is that of greater “ownership” of local revenue resources and corresponding reduction of discretionary central transfers. This should remove local incentives to “free ride” on the national taxpayer, allowing a more evaluative demand and better constrained supply. There is also an issue for fiscal sustainability: the more local governments can rely on the growth of local revenue sources to fund their expected spending growth – notably in health and old age care, infrastructure and education – the less dependent they are on the vagaries of intergovernmental transfers to balance their budgets.

34. According to Ahmad, Hewitt and Ruggiero (in Ter-Minassian, 2007), efficiency gains largely depend on the responsiveness of local government spending to the preferences of citizens in different localities, and local governments tend to be more responsive if they are more accountable for their performance.

Fiscal autonomy to reinforce accountability

Tax and revenue autonomy

34. The share of Italy's general government tax revenues that can be ascribed to sub-national governments covers only about one-third of their expenditure share (Figure 2 above). Non-tax revenues bring the share to somewhat less than half. The greater part of sub-national taxes are shared national taxes (for ordinary regions counted as transfers not own taxes), piggy-backed on national taxes, or otherwise have parameters or deductions from base constrained by central government, leaving few genuinely autonomous local taxes (Box 4). Most of these taxes are also collected by central government which may be beneficial given likely economies of scale in tax collection, and this should not infringe on local tax autonomy.

Box 4. Regional and local revenue sources

Tax revenues

Own regional taxes, which were sharply increased in the late 1990s, account for two-thirds of their total revenues. They can be either derived from national taxes or locally based. The main locally based tax, introduced in 1997, is the regional tax on business value added, IRAP (*imposta regionale sulle attività produttive*), accounting for half of total regional tax revenues (Table 5), though the State collects it and sets the basic rate. The wide base allows for a low standard tax rate (4.25%), suggesting an efficient tax and less damage to labour market incentives than social security payroll taxes which fall entirely on labour. On the other hand, the base is rather unevenly distributed and the tax only weakly obeys the benefit or correlation principle, as firms (who pay the tax) may have branches spread across regions and not perceive a close correlation between the tax they pay and the services they receive from an individual community, nor are the owners likely to be local taxpayers.

The main derived taxes also introduced in the late 1990s are the regional surcharges (*addizionale*) on the national personal income tax (IRPEF) and sharing (*compartecipazione*) of the national VAT according to the criterion of geographic origin, and surcharges on national gasoline excise taxes, all together accounting for nearly 70% of total regional revenues. However, for the ordinary regions, revenues derived from the sharing of national tax bases are officially recorded as a transfer rather than as an own tax, given that they are totally controlled by the central government, and are therefore somewhat of a grey area. There is also a regional automobile tax and other smaller excise taxes, accounting for less than 10% of total tax revenues.

As of 2000, regions were given more latitude to vary tax rates and to grant reliefs. On IRAP, they were free to vary the basic 4.25% tax rate up to 1% point on either side, also to diversify tax rates within these limits or grant deductions according to sector or contributor. On the income tax surcharge, the basic rate was raised from 0.5 to 0.9% with a possibility to vary this rate by up to 1.4%, although there is no freedom to set reliefs. Such tax rate autonomy was frozen by the central government in the 2003 Budget. Although the central government may be seen as legitimately having tried to encourage lower health and other spending, given its dual commitment to fulfil EMU targets and improve efficiency of government, this also suggests a weak guarantee of regional taxing powers.[35] It also highlights the difficulty of undertaking profound structural reforms when there is very little margin for manoeuvre in annual budgets.

IRAP and regional IRPEF surcharge rates were freed up again with the 2006 Budget, and the 2007 Budget envisages further increases in tax rate room for maneuver, in particular for regions that fail to get their health spending under control. Such regions (of which there are six) have already been compelled to increase their IRAP rates to the maximum (5.25%) by 2008; Campania and Marche have already raised theirs to 5.25 and 4.5%, respectively. For those regions, taxpayers could see a rise in their IRAP payments, partly or wholly offsetting deductions being offered by the central government in exchange for hiring on permanent contracts, especially in the poorer regions. But other regions have selectively reduced IRAP rates in support of employment: Toscana 3.25%, Veneto 3.7%, Fruili Venezia Giulia and Liguria 3.24% for special categories like agriculture but 5.25% for banking, and Lombardia 3.25% for firms born after 2004.

The main local level taxes are the property tax (ICI) and the local surcharge on IRPEF. Similarly to the regions, the freedom to vary local surcharges on IRPEF were frozen between 2002 and 2005, but reinstated with the 2006 Budget. Municipalities are likewise taking advantage of their renewed flexibility: so far, 1 435 communes have raised

35. The Constitutional Court upheld the right of the government to freeze regional tax rates, ruling that the need to meet EMU commitments overrode regional entitlement to tax autonomy.

the tax rates for 2007 whereas 4 409 have lowered them (the remaining 2 258 having left them unchanged). The 2007 Budget also expanded the scope for updating property values for the ICI, which should allow needed expansion of the local tax base. However, the 2008 Budget Law partly reverses such trends by slightly lowering the ICI tax rate on principal residences.

Non-tax revenues

Non-tax revenues account for 10% of sub-national revenues, and include operating surpluses of public enterprises controlled by sub-national governments, fees including road taxes and health co-payments levied at the regional level, and various charges by the local governments including for utilities and services like trash collection. The local entities also have access to economic rents owing to widespread holdings in economic enterprises enjoying monopoly positions: while they appreciate having this "sure" source of finance, particularly when many traditional financing arrangements are undergoing upheavals under the federalism process, it reduces government's incentive to liberalise, distorts the market and thereby undermines the local tax base (Confindustria, 2006).

In 2001, prior to national elections, the central government cancelled co-payments on pharmaceutical products at the national level. The ability for regions to levy copayments on pharmaceutical products was introduced in September of the same year (law decree 347/2001). Copayments on ambulatory services have been foreseen at the national level since 1994. According to the 2007 budget law, copayments have also been reintroduced on medical prescriptions and first aid interventions.

For local levels, non-tax revenues are proportionately more important than for the regions. Given the overall slim revenue base for the local authorities, there is still considerable dependence on transfers including discretionary earmarked grants considered to be particularly detrimental to local incentives.

Table 5. Tax autonomy of sub-national governments[1]

Tax	Weight[2]	Margin of autonomy
Region		
Tax on company value-added (IRAP)	51.0	Tax rate variable between 3.25 and 5.25%
Surcharge on income tax	9.6	Tax rate fixed by region between 0.9 and 1.4%
Automobile taxes	6.2	Variable by 10% with respect to previous year's amount
Surcharge (substitutive) on methane gas	0.6	Amount determined by region between € 0.0052 and € 0.00310 per m^3
Tax on waste disposal	0.3	Varies between € 0.001 and € 0.0258 per kg. of waste
Tax on regional concessions	0.3	Region fixes tax on acts up to 20%
Tax on right to university studies	0.2	Varies within a given range
Tax sharing for special regions	30.0	None: fixed rates
Province		
Tax on automobile insurance	47.5	None: fixed tax
Transcription tax	27.7	Freely set up to 20%
Surcharge on electricity consumption	17.3	Variable within a given range
Tax on environment protection	4.3	Tariff set by regulation
Specific tax on waste disposal	1.3	Amount determined by region by 31 July of each year
Tax on occupation of public space	0.3	Freely set, can be substituted with a tariff decided by commune
Community		
Local property tax	58.0	Tax rate variable between 4 and 7 per thousand, depending on type of property
Tax on urban solid waste disposal	22.7	To be substituted with a tariff decided by commune
Surcharge on income tax	7.1	Freely set by end of year up to 0.5%
Surcharge on energy consumption	3.4	None: fixed rate
Local tax on advertising	1.6	Feely set, can be substituted by concession with tariff
Tax on occupation of public space	1.2	Feely set, can be substituted by concession with tariff
Right to public signs	0.4	Amount set by local regulation

1. The 2007 Budget gave communities the possibility to institute, as of 1 January 2007, a tax dedicated to partial coverage of public investments, and, as of 1 January 2008, an increased sharing of personal income tax.

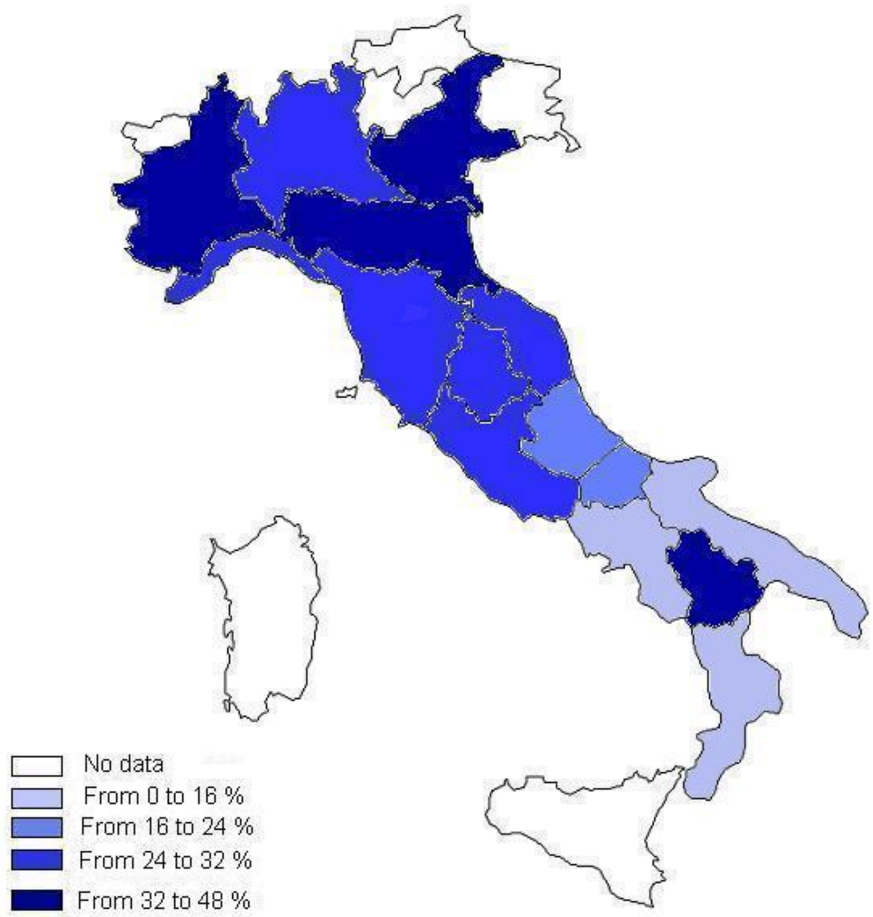
2. Weights do not add to 100 because of omitted minor taxes.

Source: Messina (2006).

35. Given that investment spending can be financed by borrowing, a better indicator of regional financing autonomy may be the ratio between own taxes and current expenses. In most southern regions this rate of cover is generally only around half that in the northern ones (Figure 7). Moreover, differences in the effective margin of flexibility, for equivalent variability in tax rates, are even greater because of the smaller absolute size of poorer regions' tax bases to start with: the remaining scope for greater tax revenues, based on a hypothetical raising of actual own tax rates to the maxima allowable, is around 1% on average in the southern and special statute regions, against 12 % in the other ones.[36] This reflects that the main regional own tax, IRAP, is unequally distributed, being based on widely varying local productive activity and heightening lagging regions' dependence on equalising transfers. On the other hand, the dynamics in the coverage ratio may be worse in the north, as spending needs there are rising faster than GDP given faster ageing and deindustrialisation. This suggests that large equalising transfers, originating in many of these regions, are not sustainable in any event. The issue for reform is to get a tax assignment with a more evenly distributed and dynamic tax base to assist regional convergence and to cope with ageing.

Figure 7. Coverage ratio by region

Own resource over current expenses ratio, in percentage, 2001



Source: OECD estimates based on Messina (2001) and ISTAT, Conti Economici Regionali.

36. See Messina (2006). The fact that the special regions' scope for manoeuvre is so small arises from the fact that tax sharing arrangements albeit generous provide no such scope as the sharing parameters are fixed.

Tax competition

36. Increased tax autonomy gives the intriguing possibility for regions to engage in horizontal tax competition as a further push to efficient service provision. However, such behaviour has been slow to crystallise in Italy. Some regions did start to exercise tax rate autonomy as central transfers were being cut in a context of tightening national budgets, before such autonomy was frozen for a time, and once the freeze was lifted some regions even began to cut taxes (Box 3). But reducing tax rates does not seem to be an option where budgets are tight and new competencies have been devolved. There also seem to be widely shared concerns in Italy about the potentially "harmful" effects of internal tax competition. However, the LEA should be sufficient insurance against that risk. Hence, the possibility of accountability-enforcing tax competition should reinforce the case for more tax rate autonomy, even if there is a limit to the extent of rate differentiation to avoid large scale tax base flight. The examples of Ireland, some US states and Switzerland show that tax competition can be highly beneficial to local development while also weakening collusion among neighbouring governments to keep taxes high.

37. Another factor inhibiting beneficial tax competition might be low inter-regional mobility, which reduces the "citizens voting with their feet" aspect of federalism. Part of the problem is a also weak operation of the benefit or correlation principle, as taxpayers perceive derived taxes only as national level taxes while the main regional tax, IRAP, is paid by firms which may even be national in scope, rather than by the taxpayers on the receiving end of most public services. The local property tax, ICI, normally follows this principle very well, and other countries' experience shows that it better allows citizens to exercise "yardstick tax competition" across communities.[37] Nonetheless, this tax is relatively underdeveloped in Italy because it is politically very unpopular (Figure 8).

38. A potentially "harmful" vertical tax competition may be the more important concern for Italy.[38] The central government controls the main bases for lower levels' taxes, IRAP, IRPEF and ICI, with local tax autonomy confined to the rates levied. But central manipulation of these tax bases for social or other policies may work at cross purposes with lower level needs, or *vice versa*. For example, recent offsetting actions on IRAP (Box 4) have implied IRAP increases in some regions in place of the cuts promised by central government. Another example of vertical externality occurs on IRPEF: in the 2007 Budget the government replaced tax credits by tax base deductions, with uncertain impacts on the base for local and regional surcharges.[39] A final example is on ICI: after devolving to municipalities the power to update property cadastre values in the 2007 Budget, a positive step, there have been proposals in Parliament to reduce effective ICI tax rates substantially by offering generous family deductions on primary houses (Box 4). This could backtrack on federalism in a fundamental way.

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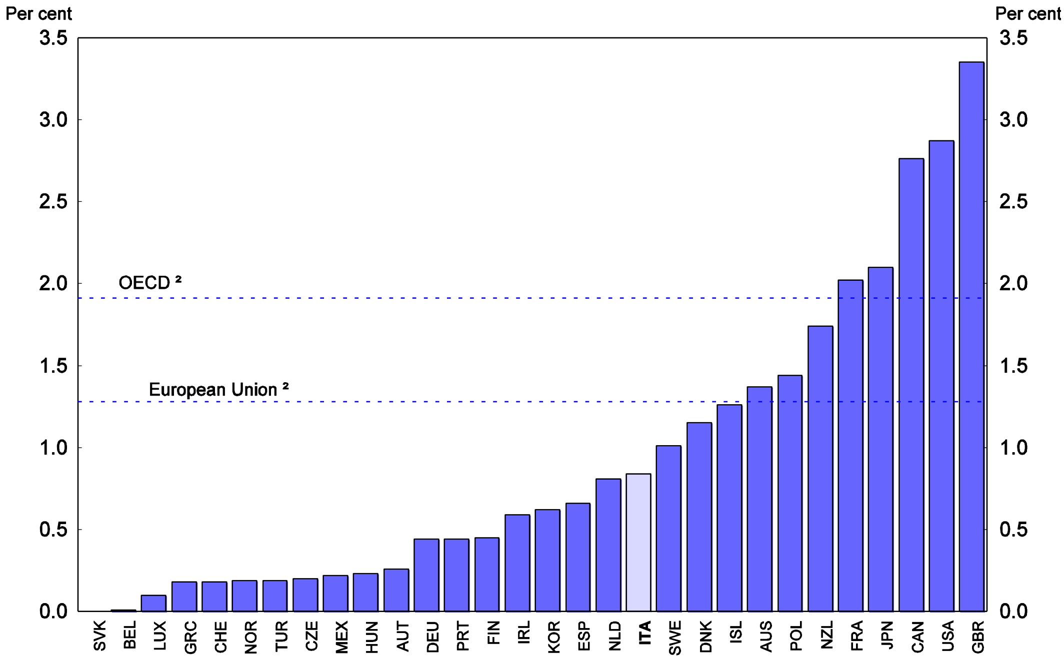
37. See Bordignon (2005).

38. According to Keen (1997), vertical tax externalities between levels of government can occur in federal structures and arise from the concurrent taxation of the same base by different government levels, so that responses to the tax policies of one level of government affect the tax base of the other. Such vertical tax externalities may imply transfers paid upward from states to federal government, entailing a perhaps negative fiscal gap.

39. See Zinardi (2007).

Figure 8. Recurrent taxes on immovable property in OECD countries
Revenues as a percentage of GDP, 2004 [1]



1. 2003 for Portugal.
2. Weighted average using 2000 GDP and PPPs.

Source: OECD, Revenue Statistics Database.

Intergovernmental transfers to balance equity and efficiency

39. A crucial aspect of fiscal federal relations is the equalisation of regional differences in tax capacity so as to allow comparable levels of public services across the national territory (particularly those covered by the national LEA) without requiring sharp differences in tax rates and hence private consumption.[40] This necessitates cross-regional redistribution of tax revenues. With large economic disparities across regions, this issue is an important and contentious one in Italy. OECD experience suggests that great caution is needed in the design of such systems. In particular, equalisation schemes have a tendency to: *i)* pose a problem for budget stability, especially if such transfers are open-ended and/or if local governments are entitled to a minimum fiscal capacity, while complicating local budget planning insofar as frequent formula adjustments render such transfers unstable; *ii)* reduce tax and development effort, especially in poorer regions and particularly if tax capacity is equalised at a rate of 100% or more; and *iii)* be prone to manipulation and ultimate ineffectiveness, given the complexity of cost equalisation in light of extensive decentralisation of expenditure (as opposed to revenue) and heterogeneity of local services. On the other hand, the choice of standardised revenue or cost bases, for example by the use of Representative Tax Systems to determine tax capacity and sophisticated methods to determine the true cost of service provision, can mitigate disincentives (Bloechligher and Charbit, 2007).

40. The Canadian constitution, for example, states that "Parliament and the Government of Canada are committed to the principle of making equalisation payments to ensure that provincial governments have sufficient resources to provide reasonably comparable levels of public services at reasonably comparable levels of taxation" (Messina, 2001).

40. Central government grants in Italy go directly to both the regional and local authority levels, funding the vertical fiscal imbalance, and there are further grant flows going from regions to local authorities within their jurisdiction. Most grants are untied, *i.e.* general purpose and not earmarked.[41] They are also considered in the statistics to be mostly mandatory, *i.e.* a running obligation of the central government bound by predefined rules. It should further be noted that around one quarter of the total grants received by the regions and the local authorities come from the EU, in terms of structural funds for project financing, which are matched by the national government upon acceptance of a feasible project proposal. This leaves about half of all central government grants going to cover current spending (Table 6).

Table 6. Main transfers

	Type of revenue	General or ear-marked transfer	Transfer origin	Equalisation transfer	Proportion of local revenue excluding borrowing
Ordinary fund	Operating	General	State	Yes	13%
Equalisation fund	Operating	General	State	Yes	3%
Consolidated fund	Operating	General	State	Yes	2%
National ordinary investment fund	Investment	Earmarked	State	No	0.1%

Source: Dexia, 2002.

41. Although the predominance of general purpose, mandatory grants over earmarked and discretionary grants following the 1990s reforms should do minimum damage to incentives of lower level governments, in fact they contain a discretionary element which does affect incentives. The amount going to each region and locality is initially set as budgets at all levels of government are (independently) formulated, and is based largely on previous years' spending.[42] However, at the end of the budget year, the amount of transfers is adjusted to cover deficits which have arisen especially at the regional level in health and transport areas. The rules for such adjustment are not clear, and seem to depend on the relative bargaining power of regions and centre: central government may try to maximise its own bargaining power by budgeting low transfers *ex ante*, and regions try to maximise their own by incurring high deficits *ex post*. The final outcome is a soft budget constraint for the regions and a perverse incentive system, rewarding profligate regions and penalising responsible ones. This contributed to the fast growth of regional spending between 2001 and 2005 (notably health, as seen).

42. Insofar as central government grants are highly unequal on a per capita basis across regions they contain an implicit redistributive element. This redistribution may be roughly calculated by positing a theoretical transfer based on population, which is simply the national mean per capita transfer, and taking differences of this amount from actual transfers. Calculations by Messina (2001) suggest a substantial de facto redistribution from rich (though not middle-income) regions to poor ones, although it is not enough to close the initial gap in per capita own resources, leaving a modest uncovered gap for regions with per capita own revenues below the national mean.[43] The resulting comparatively small difference in per capita spending levels is not necessarily undesirable, as it could reflect regional preferences (including

41. Untied grants could also be block grants, which are not used in Italy.

42. The association with health spending was made clear by a National Health Fund, through which such transfers passed. It was abolished in 2000.

43. OECD equalisation schemes on average reduce disparities in fiscal capacity by around two-thirds (Bloechliger and Charbit, 2007).

more rapid ageing in richer regions), and/or provide an incentive to improve fiscal effort by the poorer regions.

Reform proposals

Tax assignments

43. The High Commission on Fiscal Federalism (2006) proposes a revision of regional tax assignments inspired by the benefit principle. National tax sharing arrangements should finance the bulk of regions' *normal* spending levels (*i.e.* those specified by the LEA), replacing ordinary transfers and eventually IRAP. The main tax base for regional sharing would be the VAT, which as a consumption tax should be more evenly distributed hence requiring smaller equalisation transfers. The role of IRAP should be curtailed. Half of its revenue should be replaced by tobacco, lotto and stamp taxes that better satisfy the benefit principle while also being more evenly distributed. The margin of manoeuvre on IRAP would be reduced as well, while the income tax surcharge would become optional.[44] Hence, effective tax autonomy would be limited mainly to derived and local taxes other than IRAP, currently only a small portion of total revenues. There may also be scope for new local taxes, e.g. environmental taxes, given the regions' new legislative powers. It is the opinion of the Commission that the exercise of tax autonomy, even if only at the margin, should be sufficient to assure the proper functioning of fiscal federalism.

44. There seems to be a downside to heavy reliance on VAT tax sharing as proposed by the Commission. *First*, there is no participation of the regions in the setting of the sharing formula, deciding the national tax rate or granting tax relief. Thus, "ownership" of the tax seems low and it may be viewed as a transfer (as indeed it is currently), undermining regional accountability. *Second*, it is difficult for citizens to assess performance at the individual government level as they cannot tell which part of their taxes goes to the regions and which to the national government. Transparency and accountability would be enhanced if there were two separately specified VAT rates, one for the central government and one for the regions, where the latter, even if uniform, comes closer to an own tax.[45]

45. Putting more reliance on derived rather than on shared taxes has certain advantages. The allocation of the derived tax is transparent, as the surcharge applicable to the corresponding national tax is clearly stated, and some leeway in varying the level of the surcharge according to individual regions' financing needs and other objectives could easily be incorporated (as they already are), unlike tax sharing arrangements which impose a common framework for all.[46] The ideal tax for such purposes seems to be the VAT or a sales tax, displaying an elastic tax base with a smoother geographical distribution and clear adherence to the correlation principle. Indeed increasing autonomy of lower level consumption taxes seems to be a worldwide trend.[47] However, in Italy's case such a set up might be problematic, given the EU's prohibition on the setting of any sub-national VAT rate. Unless that policy changes, greater recourse may need to be made to surcharges on the national income tax as a means of increasing local tax autonomy.

46. Furthermore, the substantial advantages of the IRAP as an efficient tax – despite its drawbacks as a regional tax – should not be ignored: with a wide base, small changes in tax rates produce large revenue

44. IRAP margins of fluctuations would be reduced to 10%, from 23.5% currently (*i.e.* 4.25 plus or minus 1%) while applying the same treatment to public as to private employees (the former currently pay a fixed rate). There are also three different hypotheses regarding the income tax surcharge variability. See Messina (2006), who calculates a reduction of tax autonomy under all three hypotheses, net of transfers.

45. See also Gandullia (2005).

46. See Joumard and Kongsrud (2003).

47. Such countries include United States, India and Canada. See also Keen (2000).

variations, making the exercise of tax autonomy more effective. This tax base is also likely to be more dynamic than consumption, especially in the richer regions faced with the greater ageing challenge. Hence, the tax should probably not be curtailed or discarded, but remain as a foundation upon which to build new tax bases that better satisfy the benefit principle and are more evenly distributed across the territory, as proposed by the Commission. And crucially, the current autonomy that regions have to vary the IRAP rate should not only be preserved but augmented. Greater tax variability is the key to local autonomy and accountability.

47. Local revenue sources seem to receive scant attention in the Commission's proposals, but they should play a more prominent role in the new fiscal federalism. As local authorities are responsible for 80% of total investment spending, they will need funds in particular to shore up the national infrastructure. Raising the property tax to, say, the French level as a percentage of GDP could increase the local level coverage ratio substantially. Another benefit would be improved compliance, as this tax should be harder to evade and less distorting than other taxes. Further, local fees and charges have many attractive features from the point of view of accountability (the “benefit principle” is perfectly satisfied), as well as their market (demand-constraining) nature and potential for contestability by the private sector. But these revenue types are similarly underutilised (Box 4).

48. Even though there are likely to be significant economies of scale in tax collection, hence a comparative advantage for central government in this domain, there are also informational advantages at the local level which are currently underutilised. This might suggest giving regions and localities a greater say in tax collection, certification, and data. Thus, the 2006 Budget gave financial incentives for local authorities to improve tax collections on their territory, but without the requisite tools and authority these objectives are hard to achieve, and indeed, results of the initiative appear to have been disappointing.

49. It is appropriate, finally, that central government continue to control the regional and local tax bases as a transparent and easily comparable basis for tax competition[48] – but by the same token it should avoid using the same tax bases to pursue its own social goals, such as family policies. It will be even more important that as lower levels increase tax rates in line with decentralisation, the central level lower theirs. The current situation of unexpected cyclical tax “windfalls” may provide the ideal moment to do this.[49] A serious problem in other OECD countries in a decentralisation process has been that total tax rates tend to rise since local increases are not compensated by central decreases (France, Spain).

Equalisation system

50. The Commission proposes moving to a vertical equalisation system, judging this to be the intent of the new constitution. A horizontal system, though, may have dealt more effectively with moral hazard. A horizontal arrangement may contain equilibrating checks and balances in the form of distributional conflicts between richer and poorer regions. It is also much more transparent because the giving regions could exercise some oversight over the uses of their money by the receiving regions (and would get recognition). By contrast, in a vertical system the transfers come from an impersonal and distant centre, and there is a stronger risk of “free riding” on the general taxpayer.[50] Horizontal equalisation also favours fiscal stability as it does not eat into the central budget. The Commission argues for 100% equalisation of differential tax capacity, in contrast to the less than full equalisation of initial reform proposals in decree law 56/2000 (Box 5). In any case the transfer mechanism would now be based on objective structural indicators (to be determined), a critical aspect. Indeed, the use of clear formulae is more important than the

48. Zinardi, A. (2007), “Some notes on Italian fiscal federalism”, mimeo.

49. See OECD (2007a).

50. See Etro and Giarda (2002).

direction of the transfer: vertical transfer systems based on clear distribution rules can be transparent (*e.g.* Canada) whereas horizontal schemes can be quite non-transparent in the absence of good formula design (*e.g.* Austria).

51. It will be important that discretionary central government transfers are confined to very clear and narrow limits, perhaps as regional development earmarked grants,[51] as appears to be the intention of the constitution. Transfer systems (particularly equalisation) should be entirely formula driven, without any local negotiating power.[52] Otherwise, the risk of carrying on as at present seems too great, notably in catch-up regions. It will also be important to avoid a long drawn out transition, which could happen if no region is willing to accept cuts in its transfer level and then inflation and selective nominal freezes would be the only way to change relative endowments. Policy makers should also take a serious look at moral hazards deriving from the proposed vertical transfer mechanism with 100% equalisation formula, and reconsider the less risky approach of the earlier decree law. Whatever the model chosen, it will be vital that the rules be very explicit and that a strong political consensus be found in order that they be credible. Finally, structural reforms will be an important complement to fiscal reform in order to generate stronger local tax bases that enable regions to cope with a rules-based equalisation system.

52. The new draft law on fiscal federalism seems a promising start. It retains the earlier decree law's gradual approach from a financing system based on historical spending to one based on (yet to be defined) standard costs of providing essential levels of services. It further proposes rules of co-ordination and harmonisation among government accounts, comprehensive financing rules for all sub national levels (not just regions) including greater certainty of central government transfers, and a strengthened system of sanctions for budget slippages. However, it may face a difficult passage in Parliament. In particular, so long as there are both losers and gainers from the new system of equalisation, conflicts are bound to arise. A more politically realistic approach may therefore be needed – for example one involving resource increases for "virtuous" entities but neither cuts nor increases for the others (Galmarini and Turati, 2007).

Box 5. The 56/2000 decree

The problem of inter-regional equalisation is the central political problem of Italian federalism (Bordignon, 2005). With acute awareness of the perversity of the existing system of grant distribution, and the wish to develop greater local fiscal autonomy in line with the principles of fiscal federalism, the central government in 2000 made the decision to move to a system which eliminates altogether central government transfers and substitutes these by a strictly rules-based system of regional sharing *cum* horizontal equalisation transfers of a portion of national VAT receipts. This reform was embodied in decree law 56 of the same year, or "56/2000".

This law foresaw a large boost to regional tax income from the sharing of the national value added tax (*compartecipazione IVA*), making it the single highest source of revenue for the regions. The sharing formula allocates 38.55% of national VAT revenues to the regions as a whole, and then divides up this amount in the first instance by each region's share in national consumption (theoretical share), allocating receipts to the territory where they are presumed to have arisen. In a second step, around 40% of this total (23% of national VAT receipts) is placed in a notional national equalisation fund, which is allocated to the poorer regions at the expense of the richer ones (effective share), using a formula based on historical spending, resident population, and deviation from national mean tax capacity, the latter adjusted by a "solidarity coefficient" of 90%. Less than full (100%) equalisation of tax capacity was considered important for limiting moral hazard effects, as it left an incentive for receiving regions to develop their tax bases and improve fiscal effort. The share of the historical spending component would be 100% in the first of year of

51. This would make such transfers accompanying tools for the improvement of efficiency in local spending rather than bad strategies. See Bergvall *et al.* (2006).

52. Bordignon (2005) states that negotiation is in the "DNA" of Italian politicians and any attempt to eliminate it is likely to fail. He cannot imagine that any formula-based transfer allocation that reduces previous discretionary amounts would not be sharply contested by the affected local entity. He thus suggests giving a partial role to negotiation even in the reformed system, say covering 5% of total equalisation transfers, in order to diffuse such tendencies.

application of the new rules but gradually fall to zero, with the long run system based on structural parameters only in force by 2012, allowing poor regions enough time to develop their own tax bases. There would be collaboration in the setting of the tax sharing formula via the State-Regions Conference, with periodic modifications if necessary.[1]

In the end, however, the law was not implemented. The reasons were several: *i)* some serious mistakes were made in the calculation of transfers during the first attempted implementation of the law; *ii)* regions in general resisted moving from the long-standing negotiated system of transfers to a rules-based one; and *iii)* the constitutional reform law of 2001 was apparently inconsistent with the decree law of the previous year, as it gave a prominent role to vertical transfers in the system of equalisation (even though the same government was at the origin of both laws). Nevertheless, 56/2000 remains highly relevant as a reference point for proposals to reform the system of fiscal federalist financing. In particular, in its insistence on eliminating ordinary transfers and virtual financial self-sufficiency of regions, the model presented by decree law 56/200 appears fully consistent with article 119 of the reformed Title V of the constitution (see Box 1).

1. The OECD considers tax sharing receipts as own regional taxes if the sharing formula contains no discretionary elements by central government, cannot be changed more frequently than once per year, and does not include any inclusion of “needs” in the sharing formula. See Bloechliger and King (2006). In Italy’s case, there is no participation of the regions in the setting of the formula, or in tax rates or relief, nor do they have any certainty that it can be changed at will by the central government. This is why The Italian authorities (correctly) define such revenues as transfers rather than tax revenues of the regions.

Fiscal rules for budget discipline

Internal Stability Pact

53. Fiscal rules at sub-national levels help to ensure coherence of macroeconomic objectives, in particular the maintenance of global fiscal discipline as fiscal responsibilities become more diffuse. Since entry into the EMU, Italy has sought to engage all levels of government in its effort to abide by the Stability and Growth Pact (SGP) by establishing an “Internal Stability Pact” (ISP). The ISP is set within the framework of the annual Budget Law of the central government, with prior consultation of lower levels. Italy's deficit has exceeded the 3% of GDP upper limit for the last 4 years but in actuality, the rule was adhered to in all years from 2000 to 2004 at all 3 aggregate levels – regional, provincial, and local – with objectives even surpassed (Annex 1.). Thus, unless budget slippage could be entirely attributed to central government, it appears that the rule was not very stringent or coherent with the national SGP target. Importantly, health spending was the subject of a separate pact that was persistently violated.

54. What may be worse, substantial year to year variability in the ISP has introduced major uncertainty into budgeting frameworks, greatly complicating the ability to pursue wise budget management (Annex 1). Spending ceilings, introduced in 2005 and 2006, may not be very effective for bottom-line budget discipline, especially as they exclude a number of spending items, while infringing on already weak lower level autonomy.

Enhancing credibility

55. In order to take advantage of the efficiency gains induced by decentralisation, it is crucial that a rigorous budgetary discipline is achieved (Ter-Minassian, 1997). It follows that a serious rethinking of the Pact is needed. The 2007-11 DPEF states that if fiscal federalism is to be implemented in full, it will be necessary to draw up a new framework of reference that includes stability, consistency, compliance with European parameters and respect for the administrative autonomy of the local authorities. Some useful guidelines that have been noted in the critical literature are:[53]

53. See, *e.g.* Patrizi *et al*. (2005), IMF (2005), and Franco *et al*. (2004).

1) coverage and intermediate targets of the rule should be consistent with the fiscal target to which Italy as a whole is subject, implying that all local entities and budget lines should be covered and the balance should be targeted;

2) better information is needed on local budget performance if the Pact is to be adequately monitored by government, markets and citizens; this includes stability and transparency of rules and regulations, and convergence of accounting rules, reporting and publishing requirements to national best practice (e.g. accrual accounts); the establishment of an independent body to oversee these processes may be necessary;

3) strengthened co-ordination of budget policies and management across government levels would lend credibility to rules, for example by giving bilateral State-Regional/Provincial/Local Conferences a more formal and binding role; the conferences should meet at the start of the budget process for ex ante budget co-ordination, not at the end for haggling over ex post funding of regional deficits;

4) as partially introduced in Italy for 2007, in the case of noncompliant behaviour necessitating national government interventions, strong sanctions should be imposed on a) the responsible local public officials, at the extreme leading to a temporary management take-over by the central government, and b) the citizens who elect them, in the form of higher taxes and co-payments to help cover financial deficits; this would also require setting national-level rules on how the sanctions would be applied in a non-discriminatory manner across regions;

5) regions should speak for all the cities on their territory rather than each locality negotiation separately with government, while also developing a system of consolidated regional budget accounts; and

6) a coherence between the functions attributed to lower levels and the means of financing them is needed; otherwise there is a serious problem of credibility that is only partially offset by the "tying of hands" via fiscal rules.

56. The DPEF 2007-11 wisely calls for a return to more comprehensive deficit targets, in respect of local autonomy to vary tax and spending in line with local needs and preferences. This was partly implemented in the 2007 Budget Law, which puts into place a new balance rule for all local entities (provinces and municipalities). As information on budgets should be promptly available in order to monitor such a deficit rule effectively, Italy also introduced in 2007 an extensive monitoring covering all the local entities subject to the ISP. Data are sent quarterly by the local entities themselves using a web-based system. Spending ceilings are still in the 2007 Budget for regions, however, which are introducing the new deficit rule only on an experimental basis.

57. A final problem is common to all fiscal rules: how to avoid pro-cyclical policies and excessive cuts in investment spending, which undermine development objectives in order to meet yearly targets. Here the regional and local authority budgets must be distinguished. Regional finances are more dependent on own taxes, so that revenue cyclicality is high and a compensating transfer mechanism may be needed (as in the United States). The local authorities (municipalities and provinces) are much more dependent on transfers which are immune to cyclical swings so that for them such a mechanism would not be needed. To protect investment expenditures from degradation because such cuts are more expedient politically in the short term, it may be necessary to define the balance net of investment expenditures.[54]

54. See Franco *et al., op. cit.*

Box 6. Recommendations for fiscal federalism reforms

Spending efficiency and efficacy

- Clarify national standards in social services (LEA) to reflect output rather than inputs:
  - in health, cover a basic yet adequate amount of services, using national benchmarks to derive "standard costs" by region in order to arrive at financing needs, drawing perhaps on DRG systems that have been developed in some "best practice" regions that could be used as a model for developing similar practices in other regions;
  - in education, set clear attainment and achievement standards, leaving the mix of inputs and organisation of services to regions, while providing better national testing, monitoring, and guidelines for compliance;
  - in local welfare services, define a modest social safety net, phasing in as budget conditions permit;
- Require more flexibility among tenured staff to contain devolution costs and permit local authority innovative capacities to develop; make greater use of second level bargaining at the SNG level to reflect productivity;
- Eschew rules on individual items of spending growth (such as health) and hiring freezes in the ISP, establishing instead a hard budget constraint with accompanying financing reforms as set out below.

Financing accountability

- Urgently implement article 119 of the revised Title V, based largely on recommendations of the High Commission:
  - define new regional and local tax assignments that are well correlated with spending functions, preferably on a consumption base for regions and property base for locals, with adequate tax rate autonomy; the state must define "fundamental principles" underpinning eventual regional legislative powers in this area;
  - allow regions to participate in determining a VAT sharing mechanisms while putting relatively greater emphasis on derived rather than shared taxation to improve transparency (e.g., surcharges on national income tax);
  - define a new redistribution mechanism establishing a hard lower level budget constraint, with criteria based on structural indicators. Notably, the base should be tax capacity but with less than full equalisation; the share of national VAT receipts going to fund this scheme should be calibrated to standard costs for basic services; a relatively rapid transition should be foreseen;
  - set clear limits while also leaving some flexibility on discretionary transfers for "exceptional needs";
- reduce local governments' reliance on economic rents in line with greater competition in contestable market services while increasing user fees and co-payments to better regulate demand and establish correlation.

Credibility of fiscal rules

- Strengthen fiscal discipline of sub-national governments with credible sanctions in case of current deficits, *e.g.* by holding responsible local officials accountable and continuing to raise IRAP rates in deficit regions as an incentive to better control health spending;
- The Internal Stability Pact should be made more stable in targets and coverage and be consistent with the objectives of the GSP, covering all entities and the entire non-investment budget balance including health;
- Strengthen the role and legitimacy of the state-regional-local conferences, meetings taking place at the start rather than end of the budget cycle; streamline processes with more internal co-ordination among sub-national governments;
- Develop transparent and nationally uniform budget accounts, starting with regional health enterprises with external audits, as these are needed to allow proper monitoring and surveillance by national government and civil society.
- Good rules should complement and reinforce an internally coherent system of fiscal federalism, not try to impose discipline on a structurally flawed system. Hence the reforms set out in this box all go hand in hand.

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ANNEX 1. INTERNAL STABILITY PACT

Table A1. Respect of Internal Stability Pact in 2000-04

Province (in millions of euros, cash basis)

	2000	2001	2002	2003	2004
Total analysed	81	97	99	79	96
A. programmed objectives	-66	-235	323	498	422
B. Financial balance	589	372	567	934	947
Difference (B-A)	**655**	**606**	**245**	**435 478**	**525**

Community (in millions of euros, cash basis)

	2000	2001	2002	2003	2004
Total analysed	942	965	1 758	1 065	1 015
A. programmed objectives	-3 493	-3 766	-4 643	-6 099	-6 894
B. Financial balance	-3 435	-3 763	-9 987	-4 634	-4 565
Difference (B-A)	**58**	**3**	**3 645**	**1 465**	**2 3230**

Region (in millions of euros, cash basis)

	2000	2001	2002	2003	2004
Total analysed	Total RSO	Total RSO	Total RSO	Total RSO	Total RSO
A. Programmed objectives	18 474	21 104	15 118	15 3230	15 591
B. Payment	17 201	19 650	10 639	10 796	10 714
Difference (A-B)	**1 273**	**1 454**	**4 49**	**4 534**	**4 877**

Source: Calculations from *Corti dei Conti*, various years, (*estimates).

Table A2. Yearly evolution of the Internal Stability Pact

	1999	2000	2001	2002	2003	2004	2005	2006
Reference Balance	Pact Revenues: excluding state transfers, borrowings Pact Spending: excluding capital spending, interest, financial (cash)	As in 1999, but excluding exceptional spending and revenues	As in 2000 but excluding revenues and e expenses related to functions transferred	As in 2001	As in 2002 but excluding: Income tax sharing, elections, state functions transferred to provinces and natural disasters	As in 2003 but excluding: Changes for wage contracts 2002-03, spending for amnesty instructions	No reference balance. Rule on total expenditures: current and capital	No reference balance. Rule on total expenditures: current and capital
Target	Improve trend balance in proportion to 1998 current spending (1,1% of 1998 current spending of local entities, net of interests)	Analogous to 1999, with the addition of the composition of deviations from target in 1999. Possibility of choosing among different ways of applying the rules (cumulative target 1999-2000)	Limits to the balance (cannot worsen >3% with respect to 1999)	Limits to the worsening of the balance (not >2.5% with respect to 2000) Limits to spending (cannot >106% of 2000 spending)	Limits to the balance (Provinces cannot worsen >7% with respect to 2001; municipalities balance must be < = to 2001)	Limits to the balance (Provinces cannot worsen >7% with respect to 2001 plus inflation rate; municipalities balance must be < = to 2001, plus inflation rate)	Total spending (current + capital) cannot > 110% of average spending during 2001-03 (111.5% for "virtuous" entities)	Current spending cannot >93.5% of spending in 2004 (92% for non-virtuous entities) Capital spending cannot be > 108.1% of 2004 capital spending
Sanctions	EU sanctions allocated in proportion to overshooting of objective			Reduced state transfers (later abolished)	Limits to borrowing, hiring, and intermediate consumption	Limits to borrowing, hiring, and intermediate consumption	Limits to borrowing, hiring, and intermediate consumption	As in 2005
Incentives		Reduced interest on borrowing from Cassa Depositi e Prestiti	Reduced interest on borrowing from Cassa Depositi e Prestiti	Increase in state transfers for compliant entities (later abolished)				

Source: Corte dei Conti.

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